Monetary Economics 101: The Real Bills Doctrine of Adam Smith

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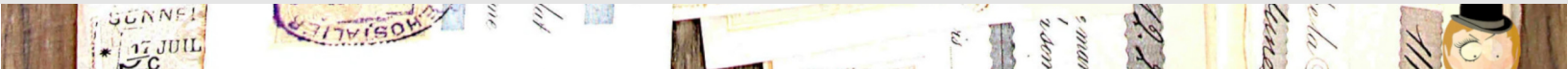

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Prologue

This work is a compilation of the thirteen lectures delivered by Professor Antal E. Fekete at the Gold Standard University seminars during the 2002 summer semester - which extended from July 1st to October 28th. These lectures belong to the course named '*Monetary Economics 101: The Real Bills Doctrine of Adam Smith*'. All the material here addressed is public and available at the Prof. Fekete's website[1]. These lectures, mixed with others, are split as single downloadable pdf links in the section *'Money & Credit'* of Fekete's webpage.

The main purpose of this anthology is to offer the reader, under the format of a *free* textbook, a more accessible and ordered way to approach the subject. Each chapter belongs to one of the correspondent lectures (i.e., chapter one recalls lecture one and so on). It was generated as a two-side Letter-size format to facilitate those who wish to print the document. A second objective, not less useful than the first, is to try to make more visible and widely diffused to the public interested on monetary theory the valuable ideas exposed by Prof. Fekete during his lectures.

Under this cycle of seminars Professor Fekete delivered at least three more courses based on monetary theory: - *Monetary Economics 102: Gold and Interest*, - *Monetary Economics 201: The Bill Market and the Formation of the Discount Rate* and - *Monetary Economics 202: The Bond Market and the Formation of the Rate of Interest.*

The main idea is to bring - under this format - the full "series" of these lectures.

[1] *www.professorfekete.com*

*Chapter **1***

Ayn Rand's Hymn to Money

(Lecture One - Inaugural Lecture)

Gold Money Is the Root of All Good; Paper Money Is the Root of All Evil

A Blueprint for a New Gold Coin Standard

Millions of people who have read Ayn Rand's 1957 monumental work "Atlas Shrugged" must have been impressed by an insert that could be entitled "Hymn to Money". This insert is buried in the 1600 pages of the novel and is difficult to find. However, it is a self-contained literary masterpiece in its own right. For these reasons it may be a good idea to publish it separately. Some remarks may be in order. Ayn Rand uses the word "money" in the sense of gold money. This may not be in line with current usage, but it is certainly correct etymologically. The English word "money" is derived from the Latin *moneta*, meaning "forewarner", epithet of the goddess Juno. Her temple on the Roman Capitolium doubled as the Mint where the gold and silver coins of Rome were struck. According to legend, during the siege of Rome by the Gauls, the sacred geese of Juno that lived around the temple forewarned the Romans with their loud cackling of the surprise attack the enemy has mounted. Under the cover of the night, the Gauls tried to scale the cliffs just below, thought to be an unassailable point of the Capitolium. The Romans, forewarned, could successfully repel the attack. In gratitude, they honored the goddess calling her Juno Moneta, or "Juno the Forewarner". And Rome went on to great things. Irredeemable currency, in Ayn Rand's words "a counterfeit pile of

paper", the output of the paper mill in Manhattan, does not deserve to be called "money". At any rate, you have been forewarned, and should be prepared for the attack of looters on your Capitol, already in progress. We still don't know whether the 911 forewarning of Juno Moneta about the approaching collapse of society has been in vain or, perhaps, there is enough moral rectitude left in America's political and economic leadership to denounce globalization, and open the Mint to gold, in order to avert the coming tragedy.

Hymn to Money

Ayn Rand[1]

Must Give Value for Value

So you think that money is the root of all evil. Have you ever asked what is the root of money? Money is a tool of exchange, which can't exist unless there are goods produced, and there are men able to produce them. Money is the material shape of the principle that men who wish to deal with one another must do so by trade, and give value for value. Money is not the tool of the moochers, who claim your product by tears, or of the looters, who take it from you by force. Money is made possible only by men who produce. Is this what you consider evil?

When you accept money in payment for your effort, you do so on the conviction that you will be able to exchange it for the products of the effort of others. It is neither the moochers nor the looters who give value to money. Neither an ocean of tears nor all the guns in the world can transform those pieces of paper in your wallet into bread you will need to survive tomorrow. Those pieces of paper, which should really be gold, are a token of honor - your claim upon the energy of the men who produce. Your wallet is your statement of hope that somewhere in the world around you there are men who will not default on the moral principle that is the root of money. Is this what you consider evil?

[1]*Ayn Rand, Atlas Shrugged, New York (Random House) 1957, pp. 410-415. (slightly edited, title and captions added).*

Wealth Is the Product of Man's Capacity to Think

Have you ever looked for the root of production? Take a look at an electric motor and dare tell yourself that it was created by the muscular effort of unthinking brutes. Try to grow a seed of wheat without the knowledge left to you by men who had to discover how to do it for the first time. Try to grow food by means of nothing but physical motions - and you'll learn that it is man's mind that is the root of all the goods produced and of all the wealth that has ever existed on earth.

But you say that money is made by the strong at the expense of the weak. What strength do you mean? It is not the strength of guns or muscles. Wealth is the product of man's capacity to think. Does it follow, then, that money made by the inventor of the motor is at the expense of others who invented nothing? Is money made by the intelligent at the expense of the fools? Or by the able, at the expense of the lazy? Money is made - before it can be looted or mooched - by the effort of every honest man, each to the extent of his ability. An honest man is one who knows that he can't consume more than he has produced.

Every Man Is the Owner of His Mind and His Efforts

To trade by means of money is the code of men of good will. Money rests on the axiom that every man is the owner of his mind and his efforts. Money allows no power to prescribe the value of your effort, except by the voluntary choice of the man who is willing to exchange the fruits of his effort with you. Money permits you to obtain for your goods and labor what they are worth to men who buy them, but no more. Money permits no deals except those to mutual benefit by the free judgment of traders. Money demands of you the recognition that men must work for their own benefit, not their injury; for their gain, not their loss - the recognition that they are not beasts of burden born to carry the weight of your misery - that you must offer them value, not wounds - that the common bond among men is not the exchange of suffering, but the exchange of goods. Money demands that you sell, not your weakness to men's stupidity, but your talent to their reason; it demands that you buy, not the shoddiest they have to offer, but the best money can find. And when men live by trade - with reason, not force, as their final arbiter - it is the best product that wins, and the best performance. It is the man of best judgment and highest ability that wins, and his reward is commensurate with his productivity. This is the code of coexistence whose tool and symbol is money. Is this what you consider evil?

The Scourge of Men Who Attempt to Reverse the Law of Causality

But money is only a tool. It will take you wherever you wish, but will not replace you as the driver. It will give you the means for the satisfaction of your desires, but will not provide you with desires. Money is the scourge of men who attempt to reverse the law of causality - men who seek to replace the mind by seizing the products of the mind.

Money will not purchase happiness for the man who has no concept of what he wants. Money will not give him a code of values if he's evaded the knowledge of what to value. It will not provide him with a purpose if he's evaded the choice of what to seek. Money will not buy intelligence for the fool, admiration for the coward, or respect for the incompetent. The man who attempts to purchase the brains of his superiors to serve him, thus trying to replace judgment with money, ends up by becoming the victim of his inferiors. The men of intelligence desert him, but the cheats and frauds come flocking to him, drawn by a law which he has not discovered, that no man may be smaller than his money. Is this the reason why you call it evil?

Money Will Not Serve the Mind That Cannot Match It

Only the man who does not need it, is fit to inherit wealth - the man who would make his own fortune no matter where he started. If an heir is equal to his money, it serves him; if not, it destroys him. But you look on and cry that money has corrupted him. Has it? Or has he corrupted money? Do not envy a worthless heir: his wealth is not yours and you would have done no better with it. Do not think that it should have been distributed among your cronies: loading the world with fifty parasites instead of one would not bring back the dead virtue embodied by the fortune. Money is a living power that dies without its root. Money will not serve the mind that cannot match it. Is this the reason why you call it evil?

Money as a Means of Survival

Money is your means of survival. The verdict you pronounce upon the source of your livelihood is the verdict you pronounce upon your life. If the source is corrupt, you have damned your own existence. Did you get your money by fraud? By pandering to men's vices or their stupidity? By catering to fools, in the hope of getting more than you deserve? By lowering your standards? By doing work you despise, for others

you scorn? If so, then your money will not give you a moment's joy or a penny's worth of happiness. Then all the things you buy will become, not a tribute to you but a reproach; not an achievement but a reminder of shame. Then you'll scream that money is evil. Evil, because it will not pander to your self-respect? Evil, because it would not let you enjoy your depravity? Is this the root of your hatred of money?

Money Is Always an Effect With You as the Cause

Money will always remain an effect and refuse to replace you as the cause. Money is the product of virtue, but it will not give you virtue and will not redeem your vices. Money will not give you the unearned, whether in matter or in spirit. Is this the root of your hatred of money?

Or do you mean that it's the love of money that's the root of all evil? To love a thing is to know and love its nature. To love money is to know and love the fact that money is the product of the best powers within you, and your pass-key to trade your effort for the efforts of the very best among men. It's the person who would sell his soul for a nickel, who is the loudest in proclaiming his hatred of money - and he has good reason to hate it, too. The lovers of money are willing to work for it. They know that they deserve it. Let me give you this rule of thumb: the man who damns money has obtained it dishonorably; the man who respects it has earned it.

The Only Substitute for Gold Money is the Muzzle of the Gun

Run for your life from anyone who tells you that money is evil. That sentence is the leper's bell of an approaching looter. So long as men live together on earth and need means to deal with one another - their only substitute, if they abandon money, is the muzzle of the gun.

When the Coercion Is the Standard, Murderers Win Over Pickpockets

But money demands of you the highest virtue, if you wish to make it or keep it. Men who have no courage, pride, or self-esteem, men who have no moral sense of their right to their money, and are not willing to defend it as they would defend their life, men who apologize for being rich - will not remain rich for long. They are the natural bait for swarms of looters that stay under the rocks for centuries, but come crawling

out at the first smell of a man who begs to be forgiven for the guilt of owning wealth. They will hasten to relieve him of his guilt, and of his life - just as he deserves.

Then you see the rise of men of a double standard - men who live by force yet count on those who live by trade to create value to back their looted money - hitch-hikers of virtue. In a moral society these are criminals, and statues are written to protect you against them. But when a society establishes criminals-by-right and looters-by-law - men who use force to seize the wealth of disarmed victims - then money becomes its creator's avenger. Such looters believe it safe to rob defenseless men, once they've passed a law to disarm them. But their loot becomes the magnet for other looters who get it from them the way they've got it from you. Then the race gets under way, and the prize goes, not to the ablest at production, but to the most ruthless at brutality. When coercion is the standard, the murderer wins over the pickpocket. And then society vanishes in a spread of ruin and slaughter.

Money Is the Barometer of Society's Virtue

Do you want to know whether that day is coming? Watch money. Money is the barometer of society's virtue. When you see that trading is done not by consent but by compulsion - when you see that in order to produce you need to obtain permission from men who produce nothing - when you see that money is flowing to those who deal not in goods but in favors - when you see that men get rich more easily by graft than by work, and your laws no longer protect you against them, but protect them against you - when you see corruption being rewarded and honesty becoming a self-sacrifice - then you will know that your society is doomed. Gold is so noble a medium that it does not compete with guns and does not make terms with brutality. It will not permit a country to survive as half property, half loot.

Paper Money Is Mortgage on Wealth That Doesn't Exist

Whenever destroyers appear among men, they start by destroying gold money, for it is man's protection, and the base of a moral existence. Destroyers seize gold and leave to its owners a counterfeit pile of paper. This kills all objective standards and delivers men into the arbitrary power of an arbitrary setter of values. Gold is an objective value, an equivalent of wealth produced. Paper money is mortgage on wealth that does not exist, backed by guns aimed at those who are expected to produce. Paper money

is a check drawn by legal looters upon an account which is not theirs: upon the virtue of the victims. Watch for the day when it bounces, marked: "account overdrawn".

When you have made evil the means of survival, do not expect men to remain good. Do not expect them to stay moral and to become fodder for the immoral. Do not expect them to produce when production is punished and looting rewarded. Do not ask who is destroying the world. You are.

Where Wealth Is Obtained by Conquest There Is Little to Conquer

You stand in the midst of the greatest achievements of the greatest productive civilization and you wonder why it's crumbling around you while you are damning its life-blood - money. Throughout man's history money was always seized by looters of one brand or another, whose names changed, but whose methods remained the same: to seize wealth by force and to keep the producers bound, demeaned, defamed, deprived of honor. That phrase about the evil of money which you mouth with such righteous recklessness, comes from a time when wealth was produced by the labor of slaves - slaves who repeated motions discovered long before by someone's mind and left unimproved for centuries. So long as production is ruled by force and wealth is obtained by conquest, there is little to conquer. Yet through all the centuries of stagnation and starvation, men exalted the looters as aristocrats of the sword, as aristocrats of birth, as aristocrats of the bureau, and despised producers as slaves, as traders, as shopkeepers - as industrialists.

The Country of Money

To the glory of mankind there was, for the first and only time in history, a country of money - and I have no higher, more reverent tribute to pay to America, for this means: a country of reason, justice, freedom, production, achievement. For the first time man's mind and money were set free, and there were no fortunes-by-conquest but only fortunes-by-work, and instead of swordsmen and slaves there appeared the real maker of wealth, the greatest worker, the highest type of human being - the self-made man - the American industrialist.

The Essence of Morality

If you ask me to name the proudest distinction of Americans, I would choose - because it contains all the others - the fact that they were the people who created the phrase "to make money". No other language or nation has ever used this combination of words before; men have always thought of wealth as a static quantity - to be seized, begged, inherited, shared, looted, or obtained as a favor. Americans were the first to understand that wealth must be created. The phrase "to make money" holds the essence of morality.

Yet these were words for which the Americans were denounced by the rotten cultures of the looters' continents. Now the looters' credo has brought you to regard your proudest achievements as a hallmark of shame, your prosperity as guilt, your greatest men, the industrialists, as blackguards, and your magnificent factories as the product and property of muscular labor, the labor of whip-driven slaves, no better than the pyramids of Egypt. The rotter who simpers that he sees no difference between the power of gold and the power of the whip, ought to learn the difference on his own hide - as I think he will.

Blood, Whips, and Guns - or Gold

Until and unless you discover that money is the root of all good, you ask for your own destruction. When money ceases to be the tool by which men deal with one another, men become the tools of men. Blood, whips, and guns - or gold. Take your choice - there is no other - and your time is running out.

Corruption of the Meaning of "Making Money"

Ayn Rand did not live to see the appalling corruption of the meaning of the phrase "making money" to include parasitic activities such as foreign exchange and bond speculation, trading options on futures, interest-rate swaps, repos, knock-in calls, knock-out puts, and so on, *ad libitum*. As long as gold was an active part of the monetary system, there was little opportunity for looters to fleece the public using exotic trading vehicles making up the $100 trillion derivative monster. But soon after gold was out of the way, white-collar looters could get the upper hand and

lay the foundations of the Tower of Babel of derivatives. Watch for the day when it crashes and buries the production facilities of society underneath.

Shame on those who have polluted the English language by applying honest words to dishonest activities, in order to cover up their immoral nature. Shame on those who write scholarly books glorifying the globalized paper money system, the exotic trading vehicles, and the trading of hot air in the name of progress, but for no other purpose than to fleece the savers and the producers.

The brightest mathematicians have not been able to plug morality into their equations, and never will. You have to make money completely amoral before you can put it into your equations. And this is exactly what they have done.

Differential equations are the physicists' most powerful tool to predict with precision the outcome when force is applied to a collection of lifeless particles. But they are wholly inapplicable to predict, even in approximation, the outcome when the particles have free will. You have to deprive men of their free will, by depriving gold of all of its monetary qualities, before you can apply the method of differential equations to a society of human individuals. And this is exactly what they have done.

Blueprint for a New Gold Coin Standard

Making money was the highest activity of men before looters invaded the nerve-center of capitalism and abolished the gold-reserve requirement for the issuance of Federal Reserve notes in 1968. Ever since "making money" has been the lowest activity of men whereby the savers and producers are fleeced of their substance. Watch for the day when the last meaningful productive job in America is exported to China. On that day American society will become a zoo, and American citizens will be reduced to the station of animals in the cage, totally dependent on the zoo-keeper for food and shelter.

Is it still possible that Americans will find their virtue, reinvent their Country of Money, and restart their essential activity of "making money" in the sense of Ayn Rand? Yes, provided that they open the Mint to gold, as ordained by the Constitution. In what follows we present a blueprint for the new gold coin standard for America.

Open the Mint to Gold

Fixing the price of gold in terms of the dollar is a non-starter. It would lead to endless bickering between creditors who want a low, and debtors who want a high fixed price of gold, guaranteeing failure. Luckily, there is no compelling reason to fix the price of gold in dollars. On the contrary, the dollar had better be left to fend for itself. The one-ounce Gold Eagle coin, already in existence, could serve as the new monetary unit. Let it soar, free of the heavy baggage of dollar-denominated debt! Let the banks, first and foremost the Federal Reserve banks among them, try to save the dollar from the ignominy of ending up in the garbage heap of history! They have totally discredited themselves as guardians of the value of the money of the people, allowing the dollar to lose 99 percent of its purchasing power during the 88 years of operations of the Federal Reserve System. Member banks should not be allowed to carry deposit accounts denominated in gold coins, lest they repeat the feat and make the value of these deposits disappear, too.

An *Act of Congress on Opening the Mint to Gold* will reestablish the constitutional right of the people to convert gold in their possession into coins of the realm. On M-Day, the Mint will be declared open to gold, and those who prefer to trade and save in terms of gold coins will, once more, be free to do so.

You may object saying that the Mint is already open to gold as shown by its production of Gold Eagle coinage, and laws are in place to allow you to make contracts in terms of gold. People have been given the choice, but they are not interested. Not so! The Gold Eagle coin program, as it exists, has been designed to throw dust into the eyes of the public. The fact is that the coins' denomination fails to be proportional to their gold content. To be sure, this idiotic provision is not the result of an oversight. It is the result of deliberate sabotage on the part of the Treasury, its own version of the "poison pill", to make these coins unfit for the purposes of a gold standard. More importantly, these coins are struck exclusively for the account of the Treasury, then promoted not as money but souvenirs. Opening the Mint to gold would mandate that the one ounce Gold Eagle coin, the monetary unit, be struck for the account of anyone tendering the correct amount and fineness of gold bullion *free of charge*. Once this is done, then - after a 70-year hiatus - the Constitutional right of the citizen to free coinage will be re-established. *The assertion that the public has been offered gold coins to trade and to make contracts in, but declined the offer, is a lie.*

Credit Unions: New Guardian of the Value of Money

The banks must not be given a federal charter to carry deposit accounts denominated in Gold Eagles for reasons spelled out above. A better guardian for the value of money will be the labor organizations of the country, including organizations of the pensioners and retired people. Each of these will be invited to apply for a federal charter to establish its own Credit Union that would carry deposit accounts in Gold Eagles. An Act of Congress on Credit Unions will authorize the mobilization of the gold reserves owned by the Treasury for the purpose of capitalizing Credit Unions, old and new. In order to be eligible for a federal charter, the Credit Union must eschew the practice of borrowing short and lending long.

Bill Market and the Discount Rate

This grass-root movement to gold coin circulation is essential to ensure that laborers be able to make their purchases with gold coins so that, in turn, they be able to get paid in gold coins. There will be no banks to extend Eagle-currency credits to productive enterprise. Such credit will, nevertheless, still be available through the bill market. An *Act of Congress on the Circulation of Bills of Exchange* will provide for the limited monetization of self-liquidating bills of exchange, drawn by the producer on his distributor, representing merchandise shipped by the former to the latter that is moving sufficiently fast to the ultimate cash-paying consumer, so that the liability will be discharged in no more than 91 days (or 13 weeks, or 3 months) out of the gold coins released by the consumer. The number 13 is not arbitrary. Thirteen weeks is the length of the seasons, marking the change in the stock of merchandise in the temperate climates such as food, fuel, clothing, recreational equipment, etc.

The Act will give the needed buoyancy to the bill of exchange so as to enable it to circulate by endorsement almost as easily as cash. The producer who gets paid for his merchandise, not in the form of gold coins but of bills accepted by distributors, will be able to use it to pay his own suppliers by endorsing the bill once more. Thus each subsequent recipient will be able to use the same bill in payment for his own supplies by further endorsement. Alternatively, any one of the recipients could discount the bill of exchange at the discount window of his Credit Union. Discounting means selling the bill for gold coins at a discount. The

amount of discount applied to the face value is determined by the discount rate and the number of days the bill has to run to maturity. Credit Unions make a market in bills. They trade them. They will sell them to you if you want to have them as an earning asset. They will buy them back from you, and will be happy to carry them to maturity, as these instruments are their most liquid earning assets. At maturity the Credit Union collects the face value of the bill from the distributor on whom the bill was originally drawn. The point is that, by that time, the distributor will have the gold coins from the sale of merchandise to the ultimate, cash-paying consumer.

In this way the source of gold coins with which to pay labor along the production channels of the merchandise, and with which to liquidate the liability upon maturity of the bill, is secure. It is for this reason that bills of exchange are called *self-liquidating*.

The Act provides that non-self-liquidating bills such as anticipation bills, accommodation bills, etc., drawn on imaginary merchandise sent on world-wide trips in imaginary bottoms, will be denied monetary privileges. Treasury bills are self-liquidating only to the extent that the Treasury has tax revenues coming to it, during the next 91-day period, in the form of gold coins. If it has cash needs in excess of these receivables, the Treasury has no authority to issue bills but must ask Congress for fresh appropriations. A bill drawn with maturity exceeding 91 days, or one that has been rolled over for a further period, is not self-liquidating and will be denied monetary privileges, too.

Bond Market and the Interest Rate

An *Act of Congress on Gold Life Insurance* will authorize the federal government to charter financial institutions for the purposes of underwriting gold life policies and gold annuities. They would be holders of gold bonds issued by the government and by companies wanting to re-capitalize in Gold Eagles. The Act will specify that these institutions may only invest in gold bonds with sinking fund protection.

The Act will authorize custom duties and excise taxes to be levied in Gold Eagles, in order to capitalize the sinking fund the government will need to stabilize the value of its gold bonds. The total outstanding gold-bonded debt of the federal government must not exceed the level that can be serviced by the sinking fund.

The interest rate on the gold-bonded debt of the government will be the lowest possible, indicating that gold is the best money available to man. The depreciation premium on gold-bonded debt is zero. Lenders know exactly what will be returned to them at the end of the loan period. By contrast, in case of debt denominated in the irredeemable dollar there is a depreciation premium incorporated in the rate of interest, representing compensation lenders demand, and receive, for the expected depreciation in the value of the monetary unit.

The Question of Legal Tender

It is understood that the paper dollar will circulate side-by-side with Gold Eagle coins, at a floating exchange rate. People can discharge their debt contracted before M-Day in either paper dollars or gold coins, at the option of the debtor. As concerning debt contracted after M-Day, provisions in the contract will apply.

Certified labor organizations will be free to bargain with the employers and sign labor contracts calling for wages to be paid either in paper dollars, or in gold coins, as decided by the membership. If the decision calls for wages to be paid in gold coins, the management of the company will immediately start drawing bills of exchange on the distributors of the products of its factories, and after a 91-day transitional period the gold coins will be available from the proceeds of bills with which wages can be paid.

Gold coin circulation is not compulsory. No legal tender laws force anyone to accept payment in the form of Gold Eagle coins. People will have the choice to demand irredeemable paper dollars in exchange for their goods and services, or in which to carry their savings, if this is what they want. But they shall not be coerced to do so: there will be no legal tender laws to force the circulation of the irredeemable dollar. The legal tender status of the Federal Reserve notes is withdrawn forthwith, effective on M-Day.

New Charter for the Federal Reserve

The Federal Reserve banks would be given a new Charter which would automatically expire should the demand for irredeemable dollars fall below 10 percent of the total demand for money, as measured in terms of gold.

It is understood that, under the new monetary regime, there would be no central bank to regulate the stock of gold-denominated money, the discount rate, or the rate of interest. These would be regulated by unfettered markets such as the gold market, the bill market, and the bond market.

Not Enough Gold in the World?

Gold is the best foundation for credit. The present monetary system has immobilized gold. In this way the world economy has been deprived of its most potent and most wholesome source of credit, gold, forced to replace it with the most unsound and most depraved kind, the irredeemable promises of devaluation-happy governments.

One often hears the argument that there is not enough gold to cement the basis of the credit structure for a dynamic world economy. This argument is not grounded in fact. There is no identifiable limit on the amount of credit that can be built on the monetary unit defined as a certain weight and fineness of gold. Another way of expressing this is that it is the *flows* of gold, as opposed to *stocks*, that matters. It is not a question how much gold a government (or, for that matter, any entity or individual) *possesses*, but how much it can *attract*. While there is a limit on the former, there is no limit on the latter, provided that gold flows fast enough.

Presently there appears to be a scarcity of gold in the world economy. However, this is merely an optical illusion. All it shows is that monetary policy lacks credibility as governments are unable to attract gold to their coffers. Worse yet, they are forced to let large chunks of their gold reserves go for a pittance as they are engaged in a desperate effort to prop up the world's shaky payments system. The anti-gold propaganda campaign has driven an increasing part of monetary gold underground. Governments have, rather unwisely, used the remaining monetary gold in their possession for backing the issuance of paper gold, that is, gold futures, options on gold futures, and other forms of forward commitments to pay gold. The outstanding commitments are in fact so huge, and they are growing so fast that, in the opinion of the private holders of monetary gold, there is no way to make good on them in an orderly way within the time period specified. The only way to keep the trading of paper gold going is through ever larger injections of central bank gold. But it is questionable that official gold will be available indefinitely for

the purpose of propping up the trade in paper gold. They won't tell you this, but central banks are conscious of the fact that their bank notes may lose purchasing power precipitously if gold reserves fall below the comfort-level of the people.

A New Golden Age

The problem therefore is to mobilize the world stock of monetary gold. This is what opening the Mint to gold is all about. Private holders of monetary gold have to be convinced that governments and central banks are ready to own up to the chicanery they have been practicing for a hundred years, and are finally ready to return to the international gold standard they abandoned in 1914. In that year they stopped using bills of exchange to finance world trade; since that time imports and exports have been the business of governments subject to quotas and official credits. In that same year the Federal Reserve System was established as the engine to monetize the debt of the U.S. government. With this kind of backing the U.S. government went ahead to finance a number of world wars in the twentieth century, bankrupting the international monetary system in the process. It is time, in the interest of the savers and producers of the world, to abandon that dysfunctional and exploitative monetary regime threatening to collapse and bury the productive facilities of the world economy under the debris.

Once a credible international gold standard is in place, private holders of monetary gold will be happy to release their holdings to the bill or bond market. The world's gold stocks will be mobilized, and the world economy will be refinanced in terms of wholesome gold-based credit. The crisis-prone financial system will be gone, replaced by the free flow of goods and capital represented by gold movements. A new Golden Age will have dawned.

America of Ayn Rand's vision, a country of reason, justice, freedom, production, achievement - a *country of money* - will emerge once more, and the regime of the irredeemable dollar will appear as a brief reactionary episode in the history of money.

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Chapter 2

Don't Fix the Price of the Gold

(Lecture Two)

Let the Gold Eagle Coin Soar Without the Heavy Baggage of Dollar Debt

The World Without Banks

I extend a hearty welcome to my audience at the first university course offered in the 21st century on the gold standard, made possible by Gold-Eagle University, an educational website to offer you knowledge put under taboo by mainstream/establishment universities. Taking this course will not get you a degree, but it may get you something more precious: a better understanding of the world, its past, present, and future.

In last week's inaugural lecture I offered a blueprint for a new gold coin standard the features of which can be summed up as follows:

1. Open the Mint to free and unlimited coinage of gold. The one-ounce Gold Eagle coin should be adopted as a monetary unit minted for the account of anyone tendering the right amount and purity of gold, free of charge.

2. To get the grass-root circulation of gold coins going, labor organizations (including those of pensioners and retired people) ought to be involved through their Credit Unions offering gold-coin deposit facilities. Banks must be excluded.

3. Short-term credit to move goods from the producer to the consumer should be provided by the bill market, rather than by the banks, on the pattern of the pre-1914 way to finance world trade with gold.

4. Long-term credit to the economy should be provided by the gold-bond market. The primary demand for gold bonds comes from financial institutions offering gold life insurance and gold annuity policies to the people. The primary supply is from the government and firms that want to operate on the basis of gold capital. Gold bonds must have a sinking fund protection. Issuers of gold bonds must see the revenues with which to retire the liability.

Parallel Monetary Standard

The first remark on this blueprint which, as far as I am aware, is new and radically different from any other that has been offered so far, is that it expressly avoids fixing the price of gold. At least for a transitional period that may last for several years, the paper dollar and the Eagle gold coins would circulate side-by side at a floating exchange rate. In other words, there would be a parallel monetary standard and the paper dollar would be free to compete with the Gold Eagle. The market should in the end decide which of the two deserved to survive. This is a major departure from historical precedents, which have all involved the stabilization of the paper currency in terms of gold. The question arises: why should we have such a complicated blueprint when a simpler one, fixing the gold price, could accomplish the same objective?

In all previous historical precedents stabilization came relatively early when the depreciation of the irredeemable currency has not yet progressed far, and a relatively minor adjustment in the gold price could solve the problem. In our case, however, the depreciation of the irredeemable dollar has progressed very far indeed. The loss of purchasing power of the dollar is in the order of 99 percent, and the factor by which the gold price needs to be adjusted is 10 (say, from $35 to $350 per ounce) or higher. While not impossible theoretically, in practice such a huge adjustment is inadmissible. There is no way to find the "right" price of gold. Any price would be arbitrary. Since the gold market is not free as long as central banks still carry huge gold reserves and may use them for bribe and blackmail, it cannot be relied upon to furnish an "equilibrium price".

Central bank selling and leasing gold is motivated by desperation rather than by design to punish those who have put their savings in gold. Central banks have been involved in the paper gold markets trading futures, options, and other commitments to pay gold in the future from inception. Little did they realize at first that the paper gold market will snowball and they would be called upon to underwrite the burgeoning liabilities. Central banks are much like the Sorcerer's Apprentice, who knew how to start the flow of paper gold but didn't know how to stop the torrent when the flow was getting out of hand. I look at central bank gold sales and leases as a desperate effort at damage control, trying to put off the day of reckoning.

Threat of Peace Between Creditors and Debtors

The gold market is supercharged emotionally for a definite reason which is never spelled out but which cannot be evaded. I am referring to the threat to the uneasy social peace between creditors and debtors. Fixing the price of gold would destroy that peace. (Incidentally, this was a problem at every previous historic episode of stabilization, too, and it would be worth while to study the history of stabilizing irredeemable currencies from this point of view.) Net creditors would insist on a lower, net debtors on a higher gold price. Nor is it hard to see why. If the official price of gold was fixed at a lower level, $1,000 debt could only be discharged through great difficulty by the payment of a greater amount of gold which creditors would welcome but debtors would strenuously oppose. If it was fixed at a higher level, then the same debt could be retired relatively easily by the payment of a smaller amount of gold which the debtors would favor but the creditors would find unacceptable. There is no way to do justice between the two contending parties. Therefore in my opinion a blueprint that calls for the fixing of the price of gold is a blueprint for failure. It would only serve to discredit the gold standard.

Banks Must Go!

But there is a second problem, too, that must be faced. Let us admit that public opinion in most countries, including the United States, is not ready yet to embrace a gold standard. (This is hardly surprising after 70 years of virulent anti-gold

propaganda on the part of the government, the banks, and academia.) In those few countries where public opinion may be receptive such as Argentina or Russia, people have lost practically all of their life savings denominated in the national currency and, rightly or wrongly, they consider the banking system as the villain. We may assume that the situation in the United States and other leading industrial countries will unfold along similar lines. When the return to a gold standard comes up as a realistic alternative, savers in the United States will find out that most of their life savings denominated in dollars is gone, and debtors will realize that there is no way for them to escape from the deadly clutches of debt short of declaring bankruptcy. There will be a tremendous backlash. Rightly of wrongly, people will blame the banks for the disaster. In this poisonous atmosphere a blueprint that calls for the banks to carry deposit accounts denominated in gold coins that represent the savings of the people is a blueprint for failure. It would only serve to discredit the gold standard. Banks must go. This includes the Federal Reserve banks as well. Clearly, it is not going to be easy to get rid of the Fed. What better way is there to do it than letting the Fed go down the tube dragged down by its monster creature, the irredeemable dollar, while society is saved from the economic pain through the life-saver of the Gold Eagle!

The Dollar-Denominated Debt Is Beyond Salvaging

The amount of outstanding dollar debt in the world is so huge that it boggles the mind. It cannot be salvaged. Either it will be 'inflated away' or it will be 'deflated away'. The latter phrase refers to bankruptcies and defaults wiping out a major part of the accumulated debt. I go further. Chances are that it is the further irresistible snowballing of debt that will turn public opinion around in favor of a gold standard. People will realize that without the golden flywheel regulator for debt creation no monetary system can last long. It will err either on the side of being too permissive and then the system will soon start spinning out of control (as it does in our case), or on the side of being too restrictive, in which case the system will seize up for lack of lubrication. Gold plays the role of the doorman that lets some loan applicants pass, while turning away others.

Be that as it may, the dollar-denominated debt is so huge that its conversion into gold-denominated debt at whatever official gold price may carry the seeds of self-destruction. The "fixed" gold price would have to be adjusted several times,

fanning the flames of anti-gold propaganda. It is just as well to let the *Gold Eagle soar without the heavy baggage of dollar debt.*

It is a safe assumption that there are not many bankers in authority in the United States who look at gold with an open mind. More likely they look at it as Public Enemy Number One. The tender plant of the new gold standard would have to be entrusted to the care of its worst enemies. It is just as well not to create an opportunity for the banks for sabotage.

Coin, Credit, Circulation

Banks will be left in place only to the extent there is demand for irredeemable dollars on the part of producers and savers. Bankers could continue financing production and could channel savings into the economy only to the extent that producers and savers voluntarily choose the dollar as their unit of account. Another segment of producers and savers will voluntarily choose the Gold Eagle as theirs. Financing production and distribution of consumer goods with gold will have to remain outside of the domain of the banks. But if not the banks, then who will do the financing? The short answer to this question is: the four C's: Coin, Credit, Circulation, Clearing. Here is a key quotation:

> *"All the perplexities, confusion and distress in America arise, not from the defects in the Constitution or confederation, not from want of honor or virtue, so much as from downright ignorance of the nature of coin, credit and circulation."*
> *– John Quincy Adams, 1829.*

The Real Bills Doctrine

This brings me to the title of this 13-week course in Monetary Economics, "The Real Bills Doctrine of Adam Smith". Although it may sound preposterous to 21st century ears, according to him *you don't need banks to extend short-term credit to finance the production and distribution of consumer goods, real bills will do It.* Adam Smith[1] elevated the Real Bills Doctrine to scientific status in the *Wealth of Nations*

[1] *Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations.*

in 1776. The market economy comes equipped with a natural, built-in clearing system that will generate all the credit needed to move goods from producers to retail outlets, provided only that the consumer wants the goods urgently enough. This credit is embodied by the real bill.

A real bill is a bill of exchange drawn by the producer (the *drawer* of the bill) on the distributor (the *acceptor* of the bill) specifying the kind, quality and quantity of merchandise shipped by the former to the latter, and specifying the sum (the *face value* of the bill) and the date on which the bill is payable (the maturity date of the bill, in any event, not more than 91 days after the date of billing). In order to be valid, the bill has to be accepted by the acceptor, by writing across its face and over his signature "I accept".

The Real Bills Doctrine of Adam Smith states that a bill of exchange can, before its maturity date, go into spontaneous circulation as the drawer will use it to pay his suppliers by endorsing the bill on the back. Everybody who receives the bill in payment thereafter can use it in a similar fashion. Endorsement signifies that the owner of the bill has assigned the proceeds to the next one. At maturity, the last owner will mark the bill "paid" and present it to the acceptor against the payment of the face value in gold coins. Alternatively, anyone who accepts the real bill in payment for goods and services, can discount it at the Discount House at any time. Discounting means selling the bill for cash at a discount, which depends on the discount rate and the number of days the bill has to run to maturity. The Discount House makes a market in real bills and acts as the residual buyer. Indeed, real bills are the most liquid earning asset that a financial institution can have. At maturity the Discount House will collect the face value of the bill from the acceptor.

The point is that as goods in urgent demand emerge in production, the credit needed to finance their move to the consumer also emerges in the form of real bills drawn by the producer on the distributor. The real bill is a non-inflationary purchasing medium which the market has endowed with *limited* monetary privileges. Non-inflationary because the face value of the bill is matched by the value of the emerging merchandise. Limited because upon maturity the purchasing medium expires as the underlying merchandise is sold to the ultimate cash-paying consumer.

In many ways the circulation of real bills is a miraculous process. Nobody designed the system of credit and clearing that makes goods in demand move along from the producer to the consumer without outside financing. Yet there it is: the real bill will do the miracle of financing production and distribution

spontaneously, *without taking one penny out of the piggy-banks of the savers, and without legal tender coercion.*

I hasten to add that the circulation of real bills assumes the underlying circulation of gold coins. To understand the concept a little better, I want you to look at a simple essential consumer good, bread, and assume that its production/distribution involves three stages: from wheat to flour to bread; handled by four tradesmen: the grain farmer, the miller, the baker, and the grocer. In the absence of clearing the pool of circulating gold coins would have to be invaded *four times* to finance the production and distribution of bread as the grain farmer, the miller, the baker, and the grocer, all four of them, would be trying to raise credit to finance their operations. But as it is, the pool of circulating gold coins need not be invaded even once. The consumer's single gold coin suffices to finance efficiently the journey of bread from the corn-fields to the dinner-table, *even in the complete absence of banks.* The movement of the "maturing bread" from the grain farmer to the grocer is matched by the parallel but opposite movement of the real bill from the grocer to the grain farmer. The three payments are made, not with gold coins, but with real bills. When finally the grocer gets paid, the single gold coin of the consumer will liquidate all four credits to which the journey of the bread has given occasion.

Self-Liquidating Credit

For this reason, the real bill is said to be 'self-liquidating'. The ultimate sale of the underlying merchandise in exchange for the gold coin of the consumer liquidates all the credit that was needed to move it forward to the consumer, whether there were four, fourteen, or forty merchants along the pipeline to handle the maturing good. We might say that as wheat "matures into" bread, so the real bill "matures into" the gold coin for which bread is ultimately exchanged. There is no need to divert gold coins to move the wheat or the flour. They will move under the steam that moves the bread, generated by the single gold coin of the consumer. Real bills are flying, as it were, on their own wings and under their own steam. That is, provided that you do have a gold coin standard. If you don't, then forget it. Irredeemable paper currency in the hands of the consumer has no steam-generating power, nor can it lend wings to real bills representing maturing merchandise. Bills will no longer fly. They no longer mature into gold coins. There are simply no real bills under a regime of irredeemable currency. They have been replaced by

a bloated money supply. The nature-ordained dynamics of monetary circulation has been destroyed. Now paper is shuffled against paper, and you need an army of parasitic bankers to do the shuffling. Credit is no longer self-liquidating.

Real bills do work. Prior to the outbreak of World War I in 1914 word trade was financed through real bill circulation with London acting as the discount house. The system worked smoothly and efficiently, showing that there is no limit on the amount of credit that could be built on a given gold basis. World trade was completely self-financing, and producers as well as consumers prospered. The volume of world trade before 1914 was so great that it took more than 75 years before it was surpassed in the 1990's, in spite of a much faster population-growth. We may conjecture that if the international gold standard and the trading system of the world financed by real bills had not been destroyed by World War I, then the volume of world trade would have increased to a level several times higher than what it is today, and the resulting prosperity would have by and large eliminated poverty from the face of the earth.

The lesson: it is not enough to give independence to the native peoples of former colonies. You also have to give them self-liquidating credit, the gold standard and real bills, which formerly made it possible for them to participate in world trade on equal terms!

Critics of the Real Bills Doctrine

In spite of this great success story, and in spite of its impeccable genealogy and a most distinguished pedigree, the Real Bills Doctrine was subjected to vicious and unfair criticism both on left (e.g., by Milton Friedman) and right (e.g., by Ludwig von Mises). Later on during this semester I shall go into the details of this great controversy between the Quantity Theory of Money and the Real Bills Doctrine which ended with the apotheosis of the former and discrediting the latter. I shall also go through the origins of the real bill and the distortions whereby the commercial paper system to furnish elastic currency for the benefit of the people was corrupted and turned into a fiat money system monetizing debt. I refer to the story of the origin of real bills circulation by the name "The Second Greatest Story Ever Told", to emphasize that its roots are embedded in moral principles. The story I shall tell in twelve episodes is a real treat which I have reserved as a reward for

my faithful audience that won't give up as the going gets tougher occasionally when we have to fight our way through some abstract passages.

All I want at this point is to indicate the importance of real bills from the point of view of the future. A complete re-evaluation of the Real Bills Doctrine is necessary. The new gold coin standard can succeed only if it is implemented in conjunction with real bill circulation. Only in this way can we ensure the needed elasticity of purchasing media to follow the seasonal and secular fluctuations in the demand for it. It is unrealistic to expect that the gold coin standard, unaided by real bills circulation, can meet these fluctuations. Indeed, the payments system would seize up during every Christmas shopping season, or whenever division of labor is refined by implementing new inventions, for reasons of dearth in the supply of purchasing media. We should remember that the supply of gold is highly inelastic (which is, paradoxically, the main reasons for gold to have become the monetary metal par excellence). So the choice is between (1) retaining the banking system which is liable to issue unsound credit thereby undermining the monetary system as it has done in the past, or (2) replacing the banking system by real bills circulation, which will not only provide the needed purchasing media, but will do it with transparency, satisfying the requirement of full disclosure. In the interest of the soundness and durability of the new international monetary system, we should decide against the banks including central banks, and opt for real bill circulation including the financing of world trade with bills of exchange payable at maturity in Gold Eagles.

Gold Coin, the Ballot Paper of the Consumer

The combination of a gold coin standard and real bill circulation is necessary if we want to put supreme economic power back into the hands of the people. The consumer must have gold coins, rather than bank notes, at his disposal as he goes to the market. The gold coin is his 'ballot paper' with which he casts his vote on a daily basis. If the consumer is denied the gold coin, then he is denied the right to vote. The act of purchasing goods with bank notes is not the same as purchasing with gold coins. In the former case the decision what to produce, how much, and when, has already been made by the issuer of the bank note. Too bad if the offering is not to the consumer's liking. He must 'take it or leave it'. He must 'grin and bear'.

In the latter case the consumer is the decision-maker himself. He is in the driver's seat. He has the whip: he can withhold the gold coin if he doesn't find what he wants. The producer and the distributor know this and they take the order directly from the consumer, not from the banker. The consumer is the boss; the producer and distributor are his most obedient servants who try to anticipate every wish of his.

It is important to see why the bank note couldn't be used to extinguish the liability at maturity. It would be tantamount to rolling the bill over, violating the absolute prohibition that maturity must never exceed the limit of 91 days. At any rate, it would take the power away from the consumer and transfer it to the issuer of the bank note, the banker. In order to safeguard the integrity and solvency of the clearing system, gold coins must be used to liquidate the credit represented by the real bill. The sovereign consumer, the ultimate guardian of the gold coin, will liquidate the credit at maturity in buying the consumer goods of his choice.

It was Lloyd W. Mints of the University of Chicago who coined the term 'real bill'. Later his student Milton Friedman popularized it in an effort to give the bill of exchange a pejorative connotation. However, the neologism backfired. The disparager hit upon a term that described the object of his scorn admirably well. A bill of exchange is a real bill in that it represents real goods making a real move to a real consumer holding a real gold coin as the carrot (if he spends it) or as the stick (if he doesn't). An irredeemable bank note is a phoney bill, representing bad faith on the part of the issuer, ignorance on the part of the producer who gives up real goods and services in exchange for irredeemable promises to pay, and bondage on the part of the saver who has been thrown into slavery by his government when his gold coin was confiscated.

Why Gold?

A paraphrase of Benjamin M. Anderson's "The Tyranny of Gold". [2]

One hundred years ago, just after the turn of century, the gold standard ruled supreme in the world of public and private finance. No economist in good standing ever dared to question its underlying principles. Governments were eager to write

[2]*Benjamin M. Anderson, Economics and the Public Welfare - A financial history of the United States 1914-1946, Chapter 64: The Tyranny of Gold, first published in 1949; 2nd edition: Indianapolis (Liberty Press) 1979, p. 414.*

gold clauses on their bonds so that they could get a higher price and a lower rate of interest. Great Britain prided itself of being the unchallenged world champion of sound money for centuries. France had successfully defended its metallic monetary standard through a century of devastating social revolutions and foreign wars. Germany, a junior member of the club of great powers, and considered an upstart by the senior members, was busy emulating the monetary policies of its peers. Germany used gold extorted from France as reparation at the end of the Franco-Prussian War to convert its monetary standard from silver to gold. The United States could do no less. After the Resumption of 1879 it enacted the Gold Standard Act of 1900 which was supposed to undo the questionable legacy of the Greenback Era for once and all, after a thorough public debate on the merits and demerits of the gold standard. Russia and Austria-Hungary were making economic sacrifices to appear every bit as credit-worthy as the other great powers in adopting a *de facto* if not a *de jure* gold standard.

Now we are at another landmark, the start of a new century and millennium. The gold standard has become a butt of jokes. It is bad-mouthed as the rich man's ploy. Little is it recognized that the gold standard, provided that its rules are meticulously observed by the banks and governments, has always been the best friend of the little guy, of widows and orphans, and in particular the wage earners. They have no time and inclination to follow the topsy-turvy world of the financial markets. The gold coin was the only form of capital to which the working man had access, until it was denied to him. It was the gold coin that had put the wage earner into the driver's seat, letting him decide what to produce when and how much. The gold coin was the ballot paper with which wage earners cast their vote of confidence or non-confidence concerning the performance of the captains of industry. When the gold coin was taken away from them, they have been disenfranchised, along with the savers and producers.

Why gold? Gold is needed as the essential agent for the litmus test of good faith in financial dealings. Gold needs no endorsement. It can be tested with scales and acids. The recipient of gold does not have to trust the government stamp on it if he does not trust the government that had stamped it. No act of faith is called for when gold is used in payments, and no compulsion is required.

Gold is highly unpopular with banks and governments. Why? Because gold is a most unimaginative taskmaster. It demands that not only men but also governments and banks be honest. It demands that they keep their promises. It demands that banks keep their demand liabilities safely within the limit of their quick assets.

It demands that governments create no debts without seeing how they can be paid. If a country has a government and banks that will do these things, gold will stay with it and will come to it from other countries. But when a country's government creates debt lightheartedly, when its central bank makes the rate of interest artificially low in buying government securities to feed the country's money market, when it permits an expansion of credit that goes into slow and illiquid assets - then gold grows nervous. Mobile capital of all kind grows nervous. There occurs a flight of capital out of the country. Foreigners withdraw their funds from it, and its own citizens send their liquid funds abroad for safety.

When suspension of gold payments eventually comes, speculators in the foreign exchange market treat paper currency most disrespectfully. They will sell it short. They will buy it only at a discount. The amount of discount is governed primarily by the expectation as to whether and when the government and the central bank will reverse its unsound policy and work back to orthodoxy and monetary rectitude.

Can we have irredeemable currency in a free country with free markets? Paper money is not merely a promissory note, of course. It is also legal tender. The government will, moreover, receive it as tax collector. Then there are various elements of patriotic support from a loyal citizenry for the paper. But beyond that, irredeemable currency embodies coercion. Legal tender, as the word is understood today, is extortion. It requires producers to give up real goods and services in exchange for irredeemable promises of uncertain value. Promises which the issuer has neither the intention nor the means to keep. All the same, the prestige of a great government and a long-established government can go far in upholding the value of its paper money even if the rational foundation for the value of the paper, redeemability, has been overthrown.

Ever since 1931 there has been a great deal of 'hot money' or nervous money in the world, jumping about from country to country seeking safety, refusing to be committed to long-term investments in any one country. Hot money jumps from one country to another not because it has found safety but because, for the moment, the former appears less safe than the latter. The origin of hot money was the excessive bank expansion of the 1920's.

Bank balances had risen tremendously under the cheap money policy of the 1920's. The nervousness of funds was due to the deterioration in the quality of excessive credit. Following World War II the policy of cheap money continued, and the problem of hot money became more pronounced, leading to a permanent state of currency crisis. The crisis continued even after the United States adopted

extreme measures to let interest rates go stratospheric in the 1970's. Today, once more, cheap money is the order of the day, and hot money may be expected to resume its *danse macabre* any time.

A country which is afraid of hot money, money which may suddenly jump to another country, has a very simple way of avoiding that danger. There is no need for controlling the movement of capital. There is no need for foreign exchange regulations. The country can keep its liquid capital within its boundaries by creating a financial environment in which money cools off and wants to stay. In other words, by having a sound currency.

It was the prevailing doctrine among economists down to World War I that governments could not coerce their peoples into accepting at face value a dishonored paper money. But World War I and, even more so, World War II, brought an immense revival and intensification of governmental power over the lives of the people. A good many new techniques of price fixing and control of foreign exchange operations were introduced. They were devised to prevent transactions which would reveal the depreciation of irredeemable paper money. After 1971 the character of these techniques changed. Emphasis was shifted from foreign exchange controls to discouraging people from buying and holding gold as an instrument of saving. The earlier direct ban on gold ownership was lifted reluctantly, but in its place there is now an elaborate effort attempting to cap the price of gold through propaganda, through the escalation of the creation of paper gold (gold futures, options on gold futures, etc.) And, of course, producers of gold are bribed and holders of gold are blackmailed. It should be clear, however, that the psychological war on gold is counter-productive. More and more monetary gold is passed from official to private holdings in addition to newly mined gold, none of which finds its way into holdings any more. When a certain threshold is reached, the tables will be turned on the governments and central banks. They will no longer be in the position to dictate the future monetary role of gold in the world.

It is to be regretted that governments are not making the necessary preparations for a smooth transfer of power. The purpose of these lectures is to enlighten public opinion, if only in a modest way, that has been thrown into a great darkness by power-hungry governments.

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Chapter 3

Credit Unions

(Lecture Three)

The Invisible Vacuum Cleaner - The Quantity Theory of Money - Destruction of the Gold Standard - And Discrediting the Real Bills Doctrine - Are Two Sides of the Same Coin - The Working Man as the Guardian of Sound Money -

Lending versus Clearing

I dedicate this lecture to the memory of Ely Moore, the first union official ever to have been elected to the Congress in 1834. He was a solid gold-standard man who believed, with Daniel Webster, that

> *"Of all the contrivances for cheating the laboring classes of mankind, none has been more effective than that which deludes them with paper money"*
> *– Daniel Webster*

In the first two Lectures I dealt with a new blueprint for a gold coin standard for America and the world, designed to avoid two great pitfalls: (1) the pitfall of breakdown of social peace between creditors and debtors, (2) the pitfall of entrusting gold coins that represent the savings of the people to the banks. In this Lecture I shall recommend that the guardianship to preserve the system of sound money should, instead, be entrusted to the laboring classes and their representatives, the Credit Unions, which would be the only financial institutions chartered to carry deposit accounts denominated in Gold Eagle coins, and which would act as clearing houses for the circulation of real bills.

Recall that real bills provide credits to move urgently demanded consumer goods from the producers to the retail outlets. We don't need banks for that. In any event, short term commercial credits arise not through *lending* but through *clearing*. As the supply of consumer goods emerge in production, purchasing media to finance its movement to the consumer emerge simultaneously through the process of clearing. No lending is involved. Coin, credit, circulation, clearing - the four C's - are central ideas that economics has ignored. We are going to revive them here in preparation to pave the way to a new gold coin standard.

The Invisible Vacuum Cleaner

Imagine that General Motors has come into the possession of a fantastic contrivance: an invisible vacuum cleaner capable of siphoning out of the pockets of every worker two dollars for every dollar that his union had won for him in wage contracts at the bargaining table. Further imagine that the invisible vacuum cleaner would operate secretly and unobtrusively (just like other contrivances did in the recent accounting scandals of Enron and Worldcom) so that the theft or embezzlement could not be detected. What would be the result of the wholesale application of the new device? Well, labor would have to run twice as fast on the treadmill just to stay abreast, while the union could pat itself on the back for having negotiated a good contract. In the meantime the public would be told again that the process of collective bargaining was working fairly and efficiently.

This parable is, of course, far too fanciful to approximate truth. General Motors would find itself in the center of a devastating legal challenge and public relation fiasco if and when the theft eventually came to light. It is doubtful, to say the least, that the existence of a contrivance of this kind could be kept in secret forever. Another problem with the scheme is the tacit assumption that the workers and their unions is a bunch of illiterate boors unfamiliar with the four rules of arithmetic.

Combating Inflation

Yet the parable is not quite as fanciful as it may appear at first sight. Actually, there is an invisible vacuum cleaner. It is called "deliberate currency debasement". Just substitute "government" for "General Motors", and pieces of the jigsaw puzzle

immediately fall into place. Unlike General Motors, the government cannot be sued for siphoning off labor's gains fraudulently and surreptitiously. The *modus operandi* of the government's invisible vacuum cleaner is known to and condemned by many a courageous critic, but to no avail. The media ignores the criticism and the public's ire is not raised. Some monetary experts are blackmailed, and some economists are bribed with fat government contracts and grants. To add insult to injury, the funds used for bribing have come out of the loot. The chorus of servile economists suppresses the voice of the critics. To the former deliberate currency debasement, which they prefer to call "inflation" with a connotation that, far from being man-made, it is a natural phenomenon, is merely a minor irritant. They see no moral dimension to the problem. As long as inflation is barely noticeable, everything is fine. Economists cheer on the government for its valiant efforts to "combat inflation" - as if it weren't the same government that has been both the engineer and the beneficiary of what is being combated.

The invisible vacuum cleaner can only be operated by the government which is free to bend the legal system to its advantage. It can even violate the Constitution with impunity at pleasure. The Constitution of the United States expressly forbids the use of "bills of credit" as legal tender, but this has never inhibited the Treasury from printing the legend on every Federal Reserve note that it is "legal tender for all obligations, public and private". Since the executive arm of the government controls the judiciary (certainly as far as jurors' compensation is concerned), no wonder that the latter condones the fraud of siphoning off labor's wage gains, and no legal challenge to the operation of the invisible vacuum cleaner can ever succeed.

The Pleasure of Being Cheated

Not only does the government bribe the economists' profession, it also uses its control over public education to throw dust into the eyes of every new generation of workers entering the labor force. Docile teachers fail to instruct their pupils about the importance of the virtue of thrift, about honesty in dealings between the government and its subjects, or between the government and its creditors. Instead, they preach the desirability, nay, the necessity for the government to manage the nation's money supply, which is just as absurd as the idea of the government's managing the nation's soap supply. The citizens are immersed in a barrage of

government propaganda from womb to tomb. Small wonder that the workers are confused and their unions are blinded to official duplicity and chicanery.

The invisible vacuum cleaner reaches not only into the pockets and bank accounts of domestic workers: it is equally effective in siphoning off the savings of foreign workers. It is the Moloch of the world. It can reach into the vaults of central banks and the mattresses of poor peasants the world over, wherever dollar bank notes or balances are held. U.S. Treasury bonds in the hand of foreigners are, in effect, irredeemable promises. At maturity the holder of the old issue can only exchange it for another scrap of paper carrying another irredeemable promise. The promisor assumes no responsibility except for the quality of ink and paper to make counterfeiting harder. If at maturity the dollar is worth only a fraction of the value of the dollar with which the bond was purchased 30 years earlier, that's too bad. But it is entirely the problem of the foreign holder of the bond. Why under these circumstances are foreigners so foolish as to buy and hold U.S. Treasury securities?

> *"Doubtless the pleasure is as great of being cheated as to cheat."*
> *– Samuel Butler (1600-1680), Hudibris, Part 2, Canto III.*

Foreign holders try to beat their own central bank. They are proud that they have outsmarted their home-grown looters as the securities of their own government lose value even faster than those of the U.S.

Presidential Lies

Former president Clinton declared from the White House that the dollar's strength was due to the "impeccable record of the U.S. to pay its obligations meticulously". He claimed that"there has never been a case of the U.S. defaulting on its bonds in the entire history of the Republic". This, of course, is an outright lie. Financial annals record two cases of American default, the first under a Democratic, and the second under a Republican president. After the Roosevelt administration devalued the dollar in 1933, it paid bondholders in diluted dollars. It did this in spite of a gold clause written into the bond. Apart from an insignificant number of unimportant cases, Roosevelt failed to make amends after in 1935 the Supreme Court reviewed the case of abrogating the gold clause, and ruled that the government had no

power to alter unilaterally the contract embodied by the bond, concluding that bondholders were entitled to the dollar-equivalent of the value reserved by the gold clause.

35 years later, in 1971, the Nixon administration defaulted on the gold obligations of the United States held by foreign governments. It did this in spite of the solemn commitment confirmed by four presidents to honor the gold redeemability of the dollar for foreign governments. The injured parties never sued C presumably as a result of some behind-the-scenes diplomatic arm-twisting. Yet this default was the root cause of the heart-rending depreciation in the value of all the currencies of the world that followed, wiping out 90 percent of the purchasing power of savings denominated in paper currencies. First the dishonored dollar went to a deep discount in terms of gold and foreign exchange. Then other governments, in an effort to protect their export industries, felt obliged to follow suit and debased their currencies to approximate the debasement of the dollar.

It is characteristic of the enormous deterioration in public morality that, while in 1935 workers and savers in the United States could still take the federal government to court charging that property was taken from them without due process of law, and in so doing they could draw attention to the official fraud and duplicity, such challenges were no longer possible in 2001. That year, when the workers' pension funds cashed in their 30-year Treasury bonds issued in 1971, they received 10 cents on the dollar in purchasing power. The missing 90 cents represented wealth stealthily confiscated by the government. But since the law does not allow a distinction between the 1971 and the 2001 dollar (in spite of the hypocrisy that the government's own Labor Department explicitly makes such a distinction for *approved* purposes), the government is unconstitutionally taking from the working and saving public.

Nothing shows the success of official brain-washing through public education and through the activities of economists in the pay of the government more clearly than the fact that the unions are not protesting the progressive and stealthy confiscation of wealth held by their pension funds, and neither the Congress nor the media took Mr. Clinton to task for lying publicly about the dismal history of the dollar.

The Quantity Theory of Money

How could the government, to which the Constitution granted only limited and carefully enumerated powers, grab unlimited power symbolized by the invisible vacuum cleaner? How could the government get away with robbing workers of their wage gains and savers of their savings, not only in this country, but world around? How could we account for the travesty that the government, while doing these things with impunity, earns high praise for "combating inflation"?

The short answer to these difficult questions is that the government has, over a period of time involving several generations, successfully indoctrinated people with a most dangerous and vicious doctrine, the Quantity Theory of Money. According to it the value of money is determined, not by its quality, but solely by its quantity. The obvious motivation of the Quantity Theory is the *a priori* removal of all moral considerations from the debate on debt-based money. Since regulating the quantity of money involves regulating the banking system, it follows that the task can only be entrusted to the government. Only the government can make the ponderous decisions impartially which are involved in the problem of increasing the quantity of money in uniform doses, year in and year out. The Quantity Theory of Money uses an impressive array of mathematics such as the Equation of Exchange $MV = PQ$ (where M is the stock of money, V is the velocity of money in circulation, P is the price level, and Q is the physical volume of transactions). The purpose of the exercise is to persuade the uninitiated that human action, just like mechanical action, can be reliably predicted via mathematical formulas. However, individuals are not molecules and, therefore, the essence of human action cannot be captured by equations. Human individuals have what molecules have not, namely, free will. You may plug in space, time, mass, force, etc., into your equations. But you can never plug in free will.

The trouble with the Quantity Theory of Money is that it is palpably false. Monetarists have utterly failed to come up with a universally acceptable definition of money. This is evident from the proliferation of the monetary aggregates M1, M2, M3, …, etc., ad nauseam. (Milton Friedman tried to get around the problem by confining his version of the Quantity Theory called "monetarism" to "high-powered money" defined as the deposit liabilities of the Federal Reserve banks. Nice try, but has anybody ever used high powered money to buy a loaf of

bread?) If we cannot agree on what money is, then how can we expect to regulate its quantity? Monetary scientist Walter E. Spahr [1] had this to say in 1954:

> *"Apparently no quantity theory of money which has thus far been stated has validity... The evidence alone is sufficient to dispose of such an assumption. But, the reasons for the lack of relationship between the supply of currency and prevailing prices need to be understood. Currency is a two-dimensional entity. Besides supply there is velocity. Often velocity - the rapidity with which the supply of currency is used - is a more important factor than is the supply of currency in affecting prices"*

The Federal Reserve Act of 1913

It could be objected that it is hardly fair to blame the government for the outcome of a scientific debate that has ended with the triumph of the Quantity Theory of Money. This triumph, it is alleged, has come about through meticulous statistical research, not through crude government interference with scientific inquiry. Or did it, really? To adjudicate this issue it will be necessary to examine how the competing doctrine, the *Quality* Theory of Money, also known as the Real Bills Doctrine, has been dethroned and ostracized through the crudest interference in science by the strong arm of government. The Real Bills Doctrine, as we know, has the most impressive credentials. Adam Smith made it the corner stone of his *Wealth of Nations* in 1776. It has served as the scientific basis on which the monetary system of the German Reich was constructed after it adopted the gold standard in the 1870's.

To tell the truth, the Federal Reserve Act of 1913 was also crafted on the scientific basis of the Real Bills Doctrine. The Federal Reserve was conceived as a *commercial-paper based system with the real bill as the only asset category eligible for re-discounting*. In more detail, real bills were the only type of paper the Federal Reserve banks were by law allowed to purchase from their member banks. Treasury bills were ineligible. The Federal Reserve banks were not allowed to monetize government debt. The original Act refused to give the Treasury a free ride. The idea was that government debt ought to be exposed to the vicissitudes of

[1] *Relation of Currency Supply to Economic Growth, by Walter E.Spahr, The Commercial and Financial Chronicle, New York, January 21, 1954.*

the market, without offering it refuge in the portfolio of the Federal Reserve banks. The only way these banks could come into possession of government securities was through a penalty-provision. Whenever gold reserves fell below the legal limit of 40 percent of note and deposit liabilities, the Federal Reserve bank was assessed a tax penalty on a progressive scale. It had to make up the deficiency by putting government securities in the asset portfolio, but there was a tax penalty on the interest income from those securities amounting to several hundred percent. The Act had a built-in disincentive for the banks to hold government securities in their portfolio.

However, the original Act was never put into effect. It was violated on the very day the Federal Reserve banks opened their doors for business in 1914. There was no way for the U.S. government to finance the war effort of the Allied Powers through a commercial-paper based banking system which made the monetization of government debt impossible. No problem. A subterfuge would do the trick. The Federal Reserve banks deliberately dropped their gold cover below 40 percent of liabilities, and started loading up on government securities, to punish themselves for the violation. Maybe the Treasury will 'forget' to collect the tax penalty. You guessed it: that's just what the Treasury would do. Why should it tax an activity that it liked and wanted by all means to encourage? You scratch my back, and I'll scratch yours.

Ever since 1914 every chairman of the Federal Reserve Board, and every dollar of research money spent by the banks, has served to undermine the original concept. With each amendment of the Act, the dollar was diluted. The amendments cast the net ever wider for eligible paper, with an unmistakable intent to make room for government securities in the portfolio of the Federal Reserve banks. Step-by-step, what was conceived as a commercial-paper system to furnish an elastic currency for the benefit of the people, was converted into a fiat money system to monetize government debt. The beneficiary was no longer the general public, but the federal government itself, transgressing its constitutional limits and assuming unlimited power.

Finally, the amendments to the Federal Reserve Act progressively reduced and ultimately eliminated the gold reserve requirement mandated for Federal Reserve notes and deposits in stages from 40 to 35 and then to 25 percent. On February 21, 1968, the U.S. House of Representatives voted 199 to 190, and on March 14, 1968, the U.S. Senate voted 39 to 37 to repeal all gold reserve requirements against Federal Reserve notes. (Those against deposits had been repealed earlier.) The

president signed the bill on March 19, 1968, thereby converting the dollar into fiat money. Under the original Federal Reserve Act of 1913, the government would have been forced to compete with private borrowers for the savings of the people. By 1968 the government could sell all the debt it wanted. If people wouldn't buy it, there was always a cozy corner in the portfolio of one of the Federal Reserve banks where the Treasury paper could take refuge.

Science by Government

Thus was the Real Bills Doctrine overthrown in the United States between 1914 and 1968, not by a committee of scientists acting in the service of truth, but by the same government that had overthrown the Federal Reserve Act. Scientific justification, so called, came later, to provide the fig leaf to cover up the power grab. This is a shameful chapter in the history of science showing how scientists may go out of their way to do the bidding of the powers-that-be in exchange for material advantage.

The written record of this piecemeal corruption of the banking system and dilution of the U.S. dollar is there for everybody to see, on the pages of the Federal Reserve Bulletins and research publications of the individual Federal Reserve banks, from 1914 to date. In reading these pages one cannot help but observe how the Real Bills Doctrine was gradually discredited, and the Quantity Theory of Money promoted in its place as the supreme fountain of truth and wisdom. Never ever was the question raised whether the dismal results (such as the loss of 99 percent of the purchasing power of the dollar during the 88 years on the Fed's watch) were due to the dethronement of the Real Bills Doctrine. The pseudo-research was most generously funded by the invisible vacuum cleaner. The incestuous relation between the Federal Reserve banks, and academic activities sponsored by them, make it abundantly clear that we are dealing not with *bona fide* research, but with science by government.

Human Action or Horse Action?

The Real Bills Doctrine, as well as The Wealth of Nations, were conceived by their author as merely one chapter in a more complete work on society. This

work was to be written in the great tradition of Scottish moral philosophy. In addition to economics, it was to comprise natural theology, ethics, politics, and law. Unfortunately Adam Smith (who was the professor of Moral Philosophy at Glasgow University) could never complete his great project.

By contrast, the theory of money, as it is presented today, is entirely devoid of any ethical considerations, and is completely divorced from moral philosophy. Just as Milton Friedman has described it: "even a clever horse can be trained to tread out the new money supply at a steady pace at the treadmill". But honest money is not the result of horse action or mechanical processes symbolized by the treadmill: it is the outcome of human action. Honest money cannot be obtained as a solution to the Equation of Exchange. Honest money, that the workers, widows and orphans, and other people of small means can fully trust, comes about as a result of the market process, the natural process of production aiming at satisfying the urgent and demonstrable needs of the consuming public.

Returning the Looted Gold

Milton Friedman and Anna Schwartz in their "Monetary History of the United States, 1867-1960" write that gold was nationalized in order to capture profits for the government that were to accrue later to all holders of gold, after president Roosevelt has devalued the dollar from $20.67 an ounce of gold to $35. When a fellow Democrat of the president, Senator Gore from Oklahoma, described the same sequence of presidential moves of appealing to the patriotic feelings of the citizens to turn in their gold 'temporarily', and then writing up its value, he used a somewhat different language:

> *"Henry VIII approached total depravity as nearly as the imperfections of human nature would allow. But the vilest thing that Henry ever did was to debase the coin of the realm!"*

Earlier, when president Roosevelt asked the Senator for his opinion regarding these measures, he answered: "Why, that's just plain stealing, isn't it, Mr. President?" (As reported in Benjamin M. Anderson's "Economics and the Public Welfare", Indianapolis, 1979, p. 317.)

Be that as it may, time has come to return the looted gold. Since there is no way to track down the beneficiaries of the wills of the original owners, the gold should be used for endowing the Credit Unions with capital consisting of gold. It will be the responsibility of the Credit Unions, whose shareholders are the working people of this country, to provide support for the circulation of Gold Eagles and to act as the clearing house for gold credits (real bills) to finance production and trade of consumer goods.

Only Credit Unions that have renounced the practice of borrowing short to lend long, and declared publicly that they were ready to support the new gold coin standard and the financing of the production and trade of urgently needed consumer goods through the circulation of real bills, will benefit from recapitalization in terms of U.S. Treasury gold. Only real bills, to the exclusion of accommodation bills, anticipation bills, and others of a non-self-liquidating nature, are eligible for investment purposes by the Credit Unions.

Closed Shop or Right to Work

Gold coin circulation is to be spontaneous and voluntary. No legal tender laws will force it, as those laws are presently necessary to force the circulation of the irredeemable dollar. People will be free to continue using the irredeemable dollar in exchange for their goods and services, and for the purpose of saving, if that is what they wish. But they will not be coerced to do so. The legal tender status of the Federal Reserve notes is withdrawn forthwith, effective on M-Day, the day the Mint is opened to gold. Debt contracted before M-Day could be retired either with paper dollars or with gold coins, at the option of the debtor. As far as debt contracted after M-Day is concerned, provisions in the contract apply.

Labor organizations would ask their membership to decide whether they want their wage contracts in Gold Eagle coins or in irredeemable dollars. Where labor is not organized, a committee with labor and management representatives (two labor votes for every management vote), would make that decision. This is a very delicate issue, and we must well understand that a great deal of educational effort is needed to make the labor force see the implications of what is involved, which I now proceed to outline.

Those laborers who want to retain closed shop, fixed minimum-wage rates, unemployment insurance and social security benefits, company pensions, health

and other fringe benefits, as well as long-term collective agreements to fix wages, should opt for the irredeemable dollar. The downside for them is that the value of the dollar will continue to fluctuate in terms of gold, and if history is any guide, the dollar-value of those benefits will probably decline. Those laborers, however, who prefer right to work to closed shop, and who would prefer fully funded health insurance and pension benefits defined in gold units to unfunded government health insurance and pensions schemes defined in terms of the irredeemable dollar, should opt for the Gold Eagle coins in which their wages will have to be paid. Gold wage rates may fluctuate but, in return, the threat of unemployment will be removed, and workers would be free to make their own provisions for health care and pensions. Payroll taxes on gold wages (such as Social Security levies) will not be authorized. Laborers who have originally opted for wages payable in irredeemable dollars will be given a chance to opt for wages payable in gold every time their labor contract comes up for renewal (or annually, in case of unorganized labor).

Existing labor legislation to govern collective agreements in dollar terms would not apply to wages payable in Gold Eagles. However, new legislation should provide that gold wages should be at least ten percent higher than comparable dollar wages calculated at the floating exchange rate for the Gold Eagles, in order to compensate workers who have opted for wages payable in gold for the fringe benefits available only to those workers who have opted for wages payable in irredeemable dollars.

Limited Charter of the Federal Reserve

I cannot condemn the Federal Reserve banks in strong enough terms for their part in the great embezzlement of the wage-gains of the workers for almost a century. The whole edifice of labor legislation involving monetary rewards, including fixed minimum wage rates, escalator clauses to supplement long-term wage contracts, unemployment insurance, etc., comes under what Daniel Webster described as cheating the workers, by deluding them with paper-money magic. The value of all these “achievements” is, in practice, diluted, nullified, or negated by the invisible vacuum cleaner, operated by the Federal Reserve banks. For their role in this travesty, their existing Charter must be revoked and replaced by a new one limited for a ten-year period. After that, it may be renewed for a further period of ten

years only if demand for irredeemable dollars stays above ten percent of the total demand for currency made up by the gold money component and the irredeemable dollar component, as measured in terms of gold.

Divorce the Mint From the Treasury

It is further understood that the regulation of the gold component of the nation's currency is not the task of the federal government, or central bank created by the federal government. The power to regulate the amount of gold money in circulation is reserved by the Constitution for the people of the United States of America. The symbol of this power is the United States Mint. To give better effect to this Constitutional provision than was done in the past, *the U.S. Mint should be removed from the control of the U.S. Treasury and the Executive Branch, and placed under the sole authority of the Legislative Branch, specifically under the direct control of the U.S. House of Representatives.* This is not only fitting but is also in line with the language and the spirit of the Constitution, which places all money-matters into the hands of the direct representatives of the people. It follows that a simple majority vote of the House of Representatives will suffice to originate this transfer. For the same reason, regulatory power over the Credit Unions must be retained by the U.S. House of Representatives, without the interposition of the U.S. Treasury.

The Vampire

Figure 3.1: *The above banknote, issued in 1922, was nicknamed by the German people as "The Vampire". Rotate it counter-clockwise through 90 degrees and see the vampire in the shape of an old hag (her pointed nose jutting behind the ear of her victim, and her black cap formed by his collar) as she is sucking blood from the neck of the worker.*

Figure 3.2: *German mark banknotes are tossed into a garbage bin in 1923. At this point money was more valuable as scrap paper than it was in purchasing goods and services.*

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"It Is Grossly Offensive to Hear Such Ignorant Marxist Rantings Associated With the Name of Ayn Rand"

From time to time I shall answer questions, comments and criticism from my audience related to these Lectures. Mr. Claude Cormier of Ormetal Inc., St-Basil-Le-Grand, Quebec, CANADA J3N 1H2, complains that I have called foreign exchange and bond speculation "parasitic activity". He suggests that foreign exchange and bond speculation are honest market activities making the best out of a possibly bad situation. To call these economic participants 'looters' and 'parasites' is nonsense. He concludes his remarks by adding that "it is grossly offensive to hear such ignorant Marxist rantings associated with the name of Ayn Ran".

I have written about bond speculation in my earlier pieces (Economic Consequences of Mr. Greenspan[2], January, 2002; Revisionist View of the Great Depression[3], parts 1-3, , March, 2002.) where I stated my views in greater details, and I said, in part:

Bond speculation is a parasitic activity on the body economic. Of course, this is not meant as a smear on the character of any individual. Speculators acting on their own can be, and we may assume that they mostly are, upright people. Like everybody else, they are trying to eke out a living. They are certainly not responsible for the establishment of this vicious system which, by staying the 'invisible hand', victimizes the majority. The blame is entirely on the government which is responsible for the institution of this iniquitous system which, rather than promoting social cooperation, pits one citizen against the other.

I made it clear that the real culprits are the big banks. Small speculators could never create and feed a $100 trillion derivatives monster. I find it interesting that Mr. Cormier posted the link to my Lecture, 'ignorant Marxist rantings' and all, on his mailing list without giving me the courtesy of prior notice.

[2] *https://www.gold-eagle.com/article/economic-consequences-mr-greenspan*
[3] *https://www.gold-eagle.com/article/revisionist-view-great-depression*

Chapter 4

The Two Sources of Credit

(Lecture Four)

Lending versus Clearing M Interest Rates versus Discount Rate - Uses and Abuses of Credit M Social Circulating Capital - Condemning the Regime of irredeemable Currency M -

Monetary System Tied to Negative Rather Than Positive Values

I dedicate this Lecture to the memory of Ludwig von Mises, monetary scientist and teacher, who exposed the motives for Gold Wars as follows:

> *"The struggle against gold which is one of the main concerns of all contemporary governments must not be looked upon as an isolated phenomenon. It is but one item in the gigantic process of destruction which is the mark of our time. People fight the gold standard because they want to substitute national autarky for free trade, war for peace, totalitarian government omnipotence for liberty."*
> *– Ludwig von Mises* [1]

1972 was a milestone in the history of money and credit. Previously, in the world's most developed countries, money (and hence credit) was tied to a positive

[1] *Human Action, Chapter XVII, Section 19.*

value: that of a well-defined quantity of a good of a well-defined quality. In 1972 this tie was cut. Ever since, money has been tied not to positive but to negative values - that of debt instruments. This innovation had two immediate consequences, both of which are pointedly ignored in the scholarly literature on the subject:

1. The option to reduce the world's total debt in the course of normal payments has been lost: total indebtedness could only be reduced through default or through currency depreciation.

2. Governments have lost the option to balance their budget. When in need of real resources, governments borrow, and borrow they must especially from foreign creditors..

As a result of these two features the world's monetary system, which previously was patterned on the model of an *anchor*, is now patterned on the model of a *weather-wane*. As the tide of unpaid and unpayable debt grows, so ebbs the value of money.

That the world has lost the facility to reduce its total indebtedness short of default or monetary depreciation becomes clear if we consider the fact that a debt of $1,000 once contracted cannot be liquidated. If it is paid off by a check, the debt is merely transferred to the bank on which the check is drawn. The situation is no better if it is paid off by tendering $1,000 in Federal Reserve notes, ostensibly the ultimate liquidator of debt. In this case the debt is transferred to the U.S. Treasury, the guarantor of the liabilities of the Federal Reserve banks (since it is clear that the latter have neither the intention nor the resources to meet these obligations). However, substituting one debtor for another is not the same as liquidating debt. The very notion of 'debt maturity' has lost all reasonable meaning previously attached to it. At maturity the creditor is coerced into extending his original credit plus accrued interest in the form of new credits, usually on inferior terms. It is true that the option to consume his capital represented by the credit is open to him. But is it not a strange monetary system, to say the least, which forces savers to eat the seed corn whenever they are dissatisfied with the quality of available debt instruments, or with the terms on which they are offered?

Monetary Growth Must Exceed the Rate of Interest

This argument also shows that the stock of money must increase at least at the rate marked by the rate of interest. Every year monetary authorities must create at least as much new money as needed to service outstanding debt, in order to keep the game of musical chairs going. No monetary policy can be implemented that would cut the rate of monetary growth *below* the rate of interest on a net basis. So much for Milton Friedman's clever horse that he said he would train to tread out new money at the treadmill. Poor horsey will be confused mightily when the rate of interest goes to 16 percent, as it did in 1980.

Governments have lost not only their option to reduce indebtedness but, more ominously, the option to balance their budgets. There is a new item in the budget that is never named, that is well-hidden, but that is increasing by leaps and bounds year after year: that part of government borrowing that is needed to provide cover for the increase of the monetary base. In other words, the budget deficit has become an autonomous, non-discretionary item in the budget that has nothing to do with financing operations, or with husbanding resources. It has become indispensable without which there is no way to inject new money into the economy, and without which the dogs of deflation would be unleashed. From a narcotic drug with all its negative side effects the budget deficit has become a standard prescription drug routinely provided for the stimulus to which society has become addicted. It is remarkable that this change in the character of the budget deficit had to be made clandestinely. The utterances of politicians about their resolve to eliminate the budget deficit is disingenuous - it cannot be done under the prevailing monetary regime on a net basis. This raises grave questions about the stability and durability of the regime. Governments are busy constructing an enormous Tower of Babel to reach to high heaven, the bricks of which are made of public debt - without giving the slightest thought to the wisdom or safety of their construction.

Anniversary Ignored

The year 2002 marks the thirtieth anniversary of the Brave New World of reckless debt breeding. A third of a century is not a great length of time in the course of history. But it might be sufficiently long to warrant an examination of this deliberate policy of heaping more debt upon unpaid and unpayable debts. Has

the policy of unbridled credit-expansion, blindly embraced by the governments of the world some 30 years ago, served the people well? Or do the negative results of this latest experimentation with the regime of irredeemable currency warrant a more careful examination of the principles involved than hitherto provided? The question is not raised, and the anniversary is being ignored. A great deal of obfuscation surrounds the issue. Officially the topic is off-limits to scholarship and research. Anyone who dares to question the legitimacy and wisdom of the world's present monetary arrangements, or challenges the doctrine that the regime of irredeemable currency represents 'progress' over 'obsolete' metallic monetary regimes, is browbeaten or subjected to ostracism and contempt by the powers-that-be. Professional standing is reserved for those who pay lip-service to the dogma that emancipation from a metallic monetary standard was a progressive, even a necessary, historical development.

Ludwig von Mises

One author whose work may help those undaunted in the pursuit of knowledge in the face of official disapprobation is Ludwig von Mises. He published his epoch-making treatise *Theorie des Geldes und der Umlaufsmittel* in 1912 at the age of 31. A second German edition was published in 1924. The work was translated into English and published under the title *The Theory of Money and Credit* in 1934. The first American edition in 1952 included an important essay entitled *Monetary Reconstruction.* Mises also developed a theory of interest contained in his *magnum opus* entitled *Human Action* (Chapters XIX and XX). He died in 1973 at the age of 92, just one year after the politicians, in the face of his persistent exhortation to the contrary, committed our planet to the regime of irredeemable currency. Ludwig von Mises was indeed a giant of monetary science in the twentieth century. It is a great tragedy of our age that world leaders deliberately ignored his teachings and advice when they chose this most perilous course, apparently irreversible, the global regime of irredeemable currency. Not a single country has been allowed to experiment with a metallic monetary standard. The world's monetary and payments system is based on coercion, probably worse than the bondage of vassals in the Middle Ages. No serious thought was put into the construction of this monetary regime. It was shaped as the world was drifting from one monetary

crisis into another, each step representing deterioration as compared with the previous stage.

Missed Opportunities

Two unique historical opportunities have been missed to change course. One was marked by the collapse of the Soviet Union and its 'Evil Empire'. It is a fact not very well known that in 1989 a delegation of high-powered monetary economists from the United States traveled to Moscow and warned Soviet leaders that the collapse of their economy was imminent. They recommended that Soviet leaders issue gold-bonded debt in order to save their power at the 11th hour. The advice came too late. The Soviet Union collapsed, and the reason was the downwards spiral of its economy as predicted. This episode is interesting for two reasons. First, the same advice was not given to the new leadership of Russia. Saving Soviet Communism from self-destruction was apparently well-worth playing the gold card. But saving Russia from the consequences of the continuing downwards economic spiral is another matter. Russia is now target for globalization. There is no place for gold-bond financing in the globalized world. But there is another reason, too, why the episode mentioned is interesting. It reveals that the gold card does have a place in the contingency planning of the managers of the world's monetary system. They may play it if and when a systemic collapse of credit occurs.

The second missed opportunity was the adoption of the Euro by the European Community. It should have been an occasion for initiating a reform of the international monetary system. Unfortunately, European politicians were motivated by greed more than by a desire to pull the world out of the morass. They created a monetary system which appears to be a carbon copy of the defunct dollar system, trying to capture part of the 100 percent seigniorage the Americans collect as a tribute from the rest of the world on global monetary reserves.

I build on the monetary theories of Ludwig von Mises. However, I wish to point out to my audience that where I find myself in disagreement with him, I will be bound neither by false admiration nor by false devotion, but will state the truth as I see it. I am convinced that Mises would not want me to act in any other way. I have already touched upon my disagreement with Mises on the question of the Quantity Theory of Money. I shall mention two others later in this Lecture.

Uses and Abuses of Credit

This long introduction to my topic on hand was necessary to set the stage. According to an old saying, a text-book on pathology makes you feel sick: in a healthy world you are bombarded with pictures of worst-case diseases. I may add that a text-book on credit will make you even sicker. In the real world as it exists today, there are only pathological varieties of money and credit to which we have all been thoroughly conditioned. In a sick world you are bombarded with pictures of healthy and wholesome varieties of money and credit. The experience will make you sick with jaundice. To lessen the shock you must be debriefed.

Credit is one of the great creative forces of civilization and one of the supporting pillars of human welfare. Next to knowledge and capital, credit is the paramount engine of progress. It can hardly be doubted that most of the prodigious amenities and inventions, technological and therapeutic advances available to modern society owe their origins to credit. To see this we have only to remind ourselves of the role of credit in capital accumulation and in capitalizing income. While capital accumulation would still be possible in the absence of credit, the amounts involved would be reduced to a pittance, subject to the physical limitations of their primitive form: hoarding. Not only would quantity be limited by physical factors, but also the reward would be far removed from effort, giving rise to psychological forces that would militate against saving. One of the great merits of credit is in the manner it works upon the time-element in the means-ends chain, shortening the effort/reward nexus, prompting the individual to work and save harder.

Credit abuse is one of the most difficult problems economics is called upon to study. Exactly the same factors that make credit a great creative force and an engine of human progress will, when abused, render it a most dangerous and obreptitious agent of destruction. With credit, just as with any sharp instrument, the more beneficial the uses, the more devastating are the abuses. Yet precisely because of the way credit operates on the time element in the means-ends chain of human action, abuses obscure the causality nexus and corrupt the feedback mechanism. Consequently, abuses persist and penalties are deferred. While deferred, they are certainly not forgiven. When the credit system can take no more abuse, cumulative penalties are meted out all at once. If it were not for compounding, penalties would be lighter and immediate adjustment would avert further punishment. There would be self-correction. But as the feed-back mechanism has been corrupted, a veritable disaster in the form of credit collapse is periodically visited upon society. There is

also a tendency to confuse the issue: a *man-made* disaster such as inflation (more appropriately called deliberate currency depreciation) is described as a *natural* disaster that mortal man can hardly control, still less eliminate.

Positivism

Positivism is a philosophical school underlying the 'scientific culture' of our age. It fanatically denies the teleological nature of economics, and is largely responsible for the confusion between capital and credit. Positivists deny that there is anything wrong with the world economy and its financial underpinnings. According to them everything in economics is to be explained in terms of causality to the exclusion of teleology. Then of course the notion of credit abuse disappears, that is, becomes unscientific. So does the notion of honorable dealings, fair play, and the sanctity of contracts. No shame is attached to breaking a promise, to pulling a surprise devaluation of the currency, or to declaring bankruptcy fraudulently - if perpetrated under a dispensation from the government. The only thing that matters is that 'human molecules' respond positively to the stimulus provided by the injection of bills of credit with no ultimate obligor into the system. Goethe described this in his famous paper money scene:

> *We printed at once the notes, large and small,*
> *Tens, twenties, fifties, hundreds and all,*
> *You can't imagine how it pleased the people, short and tall!*
> *–Goethe.* [2]

To the positivist mind it is cantankerous hair-splitting to drag eleemosynary and educational institutions, widows and orphans - who are dependent on the integrity of the currency for their economic survival - into the debate. It is not the task of my Lectures to enter into a moral argument. It should be possible to establish scientific truth without reference to a value-system. We only need to establish the fact that credit abuse corrupts the feedback mechanism without which no adjustment is possible, that it undermines and ultimately destroys the free and voluntary cooperation of individuals under the system of division of labor; that it

[2] *Goethe: Faust, Part II, Act 1.*

leads to capital consumption which is hard to detect but which, nevertheless, is a prescription for the wholesale pauperization of society.

The Two Sources of Credit

In the first three Lectures I talked about short-term credit as it arises through clearing. Now I want to put it into a wider context. There are two kinds of credit: in addition to short-term we also have long-term credit. It is very important to keep the two separate and avoid any possibility of confusion between them. Let us put the main features of the two varieties of credit side-by-side.

Short-term credit	**Long-term credit**
Definition: 91 days or less	*Definition*: 92 days or more
Source: Clearing	*Source*: Saving
Motivation: Propensity to consume	*Motivation*: Propensity to save
Instrument: The real bill	*Instrument*: The gold bond
Theater: The bill market	*Theater*: The bond market
Regulator: The discount rate	*Regulator*: The rate of interest

The dividing line of 91 days between the two is not arbitrary. It is one quarter, the length of the seasons of the year. The difference between the two kinds of credit is fundamental, and goes far beyond the difference in the maturities of credit instruments. Mises denies that sound credit can arise outside of the context of lending and borrowing. For him 'discount rate' is just another name for the rate of interest on short-term loans. Mises denies the validity of the Real Bills Doctrine of Adam Smith. He considers circulating real bills as inflationary as any other form of credit expansion.

In the following Lectures I shall show that there is no lending and borrowing involved in discounting a real bill, and that bills stand apart conceptually as well as functionally from bonds, as does the discount rate from the rate of interest.

Real bills circulate on their own wings and under their own steam. To put it more succinctly, the negotiation of the bill is not a lending but a clearing function. One of the greatest shortcoming of Mises' theory of interest is his failure to recognize the discount rate as another independent and autonomous regulator of credit. It is a mistake to believe that saving is the only source credit. Clearing is a well-recognized second source. The rate of interest is the regulator of lending, grounded in the propensity to save. The discount rate is the regulator of clearing, grounded in the propensity to consume. The relationship in both cases is inverse: the higher the propensity the lower is the rate, and conversely. For example, the higher the propensity to save, the lower is the rate of interest; the lower the propensity to consume, the higher is the discount rate. We shall study these relationships in much greater details in later Lectures.

Social Circulating Capital

Social circulating capital, a concept that we also owe to Adam Smith, is defined as that mass of finished or semi-finished goods in urgent need which is moving fast enough to retail outlets so that it is bound to be removed from the market in less than 91 days (the length of the seasons of the year) by the ultimate cash-paying consumer. A certain consumer good is part of the social circulating capital if, and only if, the bill drawn against it will circulate. The prospect of impending consumption of this goods makes it rather special. Its movement through the production and distribution channels is predictable. The uncertainty connected with the ultimate disposal of this goods is reduced to its irreducible minimum. For this reason the credit it generates will circulate. Not every consumer good is capable of generating bill circulation, e.g., slow merchandise, goods sold on an installment plan, stores of goods held back in the expectation of speculative profits due to a rise in price. We shall see that certain type of merchandise may at one point start generating bill circulation indicating that they have just become part of the social circulating capital. At other times the same merchandise may drop out of the social circulating capital, the sign of which is that bills drawn on them no longer circulate, e.g., seasonal goods such as heating fuel or seed corn. This highlights the rationale for limiting the term of real bills to 91 days. We shall also see that the composition as well as the size of social circulating capital is subject to frequent changes reflecting the shifting demand of the consumer.

Handlers of goods belonging to the social circulating capital can operate with a minimum amount of capital by virtue of the fact that bills on fast-moving goods are acceptable in trade as a means of exchange. These tradesmen are processing merchandise 'on the go', the further path of which is highly predictable. The risk that the goods won't be sold in time is negligible. Compare this with the risk of carrying merchandise that does not belong to the social circulating capital, goods that cannot be sold in 91 days. If merchandise cannot be sold in 91 days, then it may not be sold for a year until the same season of the year comes around once more. During the year fashion may change beyond recognition, and any other unforeseeable circumstance may make the merchandise unsaleable except at a loss. To cover this risk tradesmen must carry insurance in the shape of a larger capital.

Present and Future Goods

The theory of interest of Mises is built upon the distinction between present goods and future goods. Interest is just the premium people are willing to pay for the privilege of getting the present good they prefer to the corresponding future good. Therefore it is very important to know where to draw the line between the two.

This is a point where I could not bring myself to agree with the position of Mises. He states in the *Theory of Money and Credit* that secure and mature claims to gold coins are complete substitutes for them and, as such, they are able to fulfill all the functions of the gold coin in those markets in which their security and maturity is recognized. Mises categorically states that a bank note is a present good just as much as the gold coin. "A person who accepts and holds [bank] notes grants no credit - he exchanges no present good for a future good ... The note is a present good just as much as the money". (See the 1980 edition, pp. 304-305.) I must part company with Mises over this issue. My position is that the holders of gold certificates and, for the stronger reason, holders of bank notes are in fact (voluntary or involuntary) grantors of credit. What they hold is a promise to deliver a present good, not the present good itself. In other words, paper currency such as a gold certificate or a bank note is a future good. There is no point in wiping out the distinction between a present good and a promise to deliver a present good on demand, or a 'legal tender' readily exchangeable for a present good. If we admit that a bank note is a present good, then we also have to admit that Keynes is right after all in suggesting that the government has the power to create wealth out of

nothing, simply by sprinkling some ink on little scraps of paper. This is no idle quibbling or hair-splitting. This is a fundamental issue on which the theory of interest turns (and to which I plan to return in 2003 when I offer another course on the bond market and the formation of interest rates.)

The Regime of Irredeemable Currency

Both Mises and I condemn the regime of irredeemable currency. His reasoning has to do exclusively with its role causing progressive inflation. Mises subscribes to what he calls a refined version of the Quantity Theory of Money. (The refinement consists in taking into full account leads and lags in the increases in the stock of money and changes in the price level.) The difference between the position of Mises and that of Friedman is this: Mises believes that inflation caused by irredeemable currency inevitably leads to a 'crack-up boom', while Friedman believes that such an outcome can be avoided indefinitely, provided that the rate of increasing the stock of money is kept fixed at a suitably low level. If Friedman could prove his contention using cold logic then, presumably, Mises would no longer object to the regime of irredeemable currency.

My own objection is more fundamental. The Quantity Theory divorces money and credit from moral philosophy. It robs money of its ethical dimension. It makes the emergence of money a mechanical process devoid of any moral content. My own position concerning the role of money in society is closer to that of Ayn Rand. I regard the Quantity Theory a most vicious and dangerous doctrine. Its seductive simplicity and plausibility make it suitable to lull the vast majority of people into a false sense of security. It is responsible for the victims of inflation accepting the proposition that the government has a legitimate role in managing the nation's money supply, and inflation will be eliminated as soon as researchers come up with the right formula how to fine-tune it. Even if I granted that Milton Friedman were right in assuming that, with a judicious control of the money supply, the inflation could be completely eliminated (which I don't), I would still condemn the regime of irredeemable currency on moral grounds, as it disenfranchises savers and consumers. The saver can no longer control his savings. Bereft of his gold coin, his role is reduced to that of the bee: to gather honey for the benefit of the apiarist. The consumer is no longer king. Bereft of his gold coin, he has been reduced to the status of a pawn. Producers and distributors of consumer goods are

no longer his servants. They have all been put in hock to the banks. The regime of irredeemable currency represents a latter-day bondage and servitude, more vicious than any throughout the long history of humans exploiting humans. Previous forms of exploitation were overt. The slave knew he was a slave. The new forms of exploitation are covert. Slaves are encouraged to believe, as they do, that they are free or, what is more, that they are in charge.

Extended Order of Information

The 'division of knowledge' and the related idea of the 'extended order of information' were introduced by F. A. Hayek[3] in his last book *The Fatal Conceit - Errors of Socialism.* The Nobel laureate economist compared the data-collecting and data-processing mechanism of the market system to a gigantic computer that could not be replaced, imitated, or duplicated by the human brain, still less by an artificial device conceived by the human brain. The extended order of information works with a data-base whose sheer size and information-density boggles the mind. It processes, propagates, and retrieves information so efficiently that we cannot even describe it in terms of examples borrowed from other fields. This particular form of organizing knowledge is *sui generis*, one of a kind. It cannot be realized except in the context of the market system, with its continually changing prices, interest and discount rates, and with the instantaneous reactions to these changes by market participants. Without it our civilization would cease to function, production and exchange of goods would be thrown into utter confusion. Hundreds of millions would become homeless; famine and epidemic diseases would decimate the population. In future courses to be offered in 2003 on the program of Gold-Eagle University I plan to take a glimpse into the inner workings of this miraculous system of information-processing and communication, in describing the formation of the discount and interest rates in terms of marginal analysis and arbitrage.

Credit is of great interest to everybody with a modicum of intellectual curiosity, and my Lectures are designed to satisfy this curiosity. Unfortunately, the subject is usually treated in a polemic style generating more heat than light. While the literature on the subject is vast, most of it is one-sided and partisan. There are few

[3]*F. A. Hayek: The Fatal Conceit - Errors of Socialism, Ed.: W. W. Bartley III, The University of Chicago Press, 1988.*

studies explaining *sine ira et studio* the principles underlying credit and banking. I shall endeavor to relate the subject of credit to the larger problem of exchanging income for wealth and wealth for income, a new approach that I believe to be very fruitful. Only in this way can the economic functions of the rate of interest and the discount rate be brought to light.

It is hardly necessary to add that I shall try to make this study fair and candid. I have created this lecture series for the benefit of those open-minded readers who are looking for a disinterested treatment of the subject. Those who believe that government intervention in credit-relations can do no harm but that the government can, through judicious monetization of its own debt, create value and wealth, are asked to switch off the screen and read no further. My Lectures are dedicated to the refutation of latter-day orthodoxy. They represent the opposing view, however unfashionable, that the credit of the government, no less than that of the individual, can indeed be abused. The monetization of government debt and other forms of credit abuse ultimately lead to a wholesale destruction of capital, and hence to the pauperization of the entire society through credit collapse. It has happened before. The most recent episode was the Great Depression of the 1930's. It can happen again.

Today we are witnesses to the unfolding of an unprecedented historic event. The entire world is being engulfed by a tidal wave of credit expansion. The *tsunami* of the $100 trillion derivative monster is just one example. The runaway Debt Tower of Babel, based on nothing more substantial than the irredeemable promises of the U.S. Treasury - itself empty (or worse), is another.

In all historical episodes of experimenting with the regime of irredeemable currency, while some governments were churning out irredeemable bills of credit with abandon, others continued paying their bills punctiliously as contracted - that is, in specie. When the day of reckoning dawned, the latter could help the former to find their way back to the path of fiscal and monetary rectitude. In the present episode all governments of the world are merrily destroying their own credit - and with it, their command over real resources. Which quarter will rescue come from when the Debt Tower of Babel topples?

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Open the Mint to Silver, Too!

Mr. David Shapley (dshapley@dfwoffice.com) asks how the monetary system I recommend compares with the bimetallic system of the U.S. Constitution. Should the Mint be open to silver as well?

First of all, a correction. Bimetallism prescribes an official fixed bimetallic ratio between gold and silver. As the normal state of prices is dynamic rather than static, bimetallism rests on the presumption that the government can create or destroy value by fiat. It is, therefore, a faulty monetary policy which is bound to fail. The U.S. Constitution never prescribed bimetallism. It merely ordered that the Mint should be open to both monetary metals, the implication being that there would be a parallel standard of both silver and gold (at a variable exchange rate). The monetary unit was specified as the standard silver dollar.

It was the Coinage Act of 1792 that, by fixing the price of gold in terms of silver, introduced the official bimetallic ratio of 15:1. It was a mistake that gave rise to a lot of monetary mischief later, threatening social peace. The mistake was never corrected. It would have taken a Constitutional amendment to drop the standard silver dollar as the monetary unit of the United States.

In a series of Lectures of this type it is not possible to discuss every minute detail of the plan for monetary reconstruction, such as the question of silver coins, subsidiary coins, gold and silver certificates, etc. Therefore I did not discuss the role for silver. But now that the question has been raised, I have to clarify my position which is this. The monetary system that I recommend for the United States is the Constitutional one: open the Mint to both monetary metals. I recommend that the one ounce Gold Eagle coin (*minus* the silly reference on the coin to the dollar) should be adopted, instead of the standard silver dollar, as the monetary unit. *This will take a Constitutional amendment.* This change reflects a greatly increased monetary role for gold and decreased one for silver that has occurred during the past two hundred years, and the great abuse to which the dollar has been subjected by the government. But I think that the wisdom of the Constitution should be respected and silver be given its monetary role back. Let the people decide whether they prefer a dual monetary standard or a monometallic one. Mr. Shapley continues his comments raising some very interesting possibilities.

"It seems that the purchasing power of gold would be very high. I would imagine that a loaf of bread would not cost a gold coin. What about small-ticket items? I would lay odds that people would also want to carry something lighter than

coins. Perhaps cards with smithereens of perfectly weighed gold in them? Or gold certificates? However, if they choose paper once again, what is to stop the issuers of that paper to do what they have done to the old gold standard, i.e., issuing far more paper than they had gold to back it?"

It seems to me that Mr. Shapley's idea of enclosing stamped gold smithereens in Lucite cards or coin-shaped holders is a most excellent one to provide fractional coinage. For that matter, the standard Eagle Coin could also be enclosed in Lucite holders to eliminate wear and tear. No doubt, there will be a lot of discussions on these proposals once the major hurdle, the opening of the Mint to gold and silver, has been cleared.

Chapter 5

The Second Greatest Story Ever Told

(Lecture Five)

Chapters 1 to 3 - Origins of the Real Bill - The Miracle of One Gold Coin Performing the Job of Three - A Small Step for One Man, but a Giant Step for Mankind - Clearing at the Great Medieval Fairs -

The Evolution of Paper Currency

Fable has it that paper currency came into being as warehouse receipts issued by the goldsmith against gold left on deposit for safe-keeping. The owners found that they could make purchases with these warehouse receipts as easily as with gold coins. Then the goldsmith went on lending out at interest his fictitious warehouse receipts. According to this fable, the fraudulent business of the goldsmith in issuing warehouse receipts against non-existent gold was the embryonic form of the fractional-reserve banking of today.

The unsurpassable naivety of this fable raises the question how serious students of money and credit have found it possible to treat it with respect. We should credit our ancestors with more intelligence and acuity than assuming that they fell so easy a victim to such a crude swindle, or that they meekly continue to be victimized long after the fraud has been exposed. To be sure, there was fraud aplenty in the actual process of introducing bank notes but, as we shall see, it was far more subtle and far more sophisticated than the crude device of issuing warehouse receipts on non-existing gold.

In reality, the evolution of paper currency takes its origin in the invention of the negotiable bill of exchange, the real bill. This was a wonderful invention. There was nothing sinister about it. The process was perfectly natural. Some authors maintain that the bill of exchange has been around since time immemorial. Harley Withers[1] in his book *The Meaning of Money* quotes an authority as saying that the bill of exchange was, in its original form, probably nothing more than a letter of credit from a merchant in one country to his debtor: a merchant in another, requiring him to pay the debt to a third party, namely, to the bearer of the letter who happened to be traveling to the place where the debtor resided. It turned out that the bearer could with advantage assign his letter of credit to another by endorsing, and there could be several such endorsements before the letter was finally presented to the debtor for final settlement.

The only evidence that indeed there might have been such a circulation of letters of credit is an obscure quotation from Cicero. In a letter to Atticus, Cicero asks whether he could send money to his son in Athens by exchange operations. This passage is, of course, not a proof that bills of exchange circulated in Rome and its overseas possessions. Be that as it may, in view of the voluminous trade between Rome and Athens, it is possible that the acute and quick-minded Greeks devised some exchange mechanism to clear the credits arising from the trade of goods between these two busy cities.

Here we assume that bills of exchange as we know them from the earliest extant specimens came into use in Florence, Venice, and Genoa in the 14th century. Either one of these cities could have been the scene of *The Second Greatest Story Ever Told*, an attempt to reconstruct the process whereby the bill of exchange, or real bill, was invented. The story will be told in twelve chapters. I call it the 'second' greatest story (the 'first' being the Bible) in order to emphasize moral philosophy that continues to provide background to the history of money in the spirit of Adam Smith.

[1] *The Meaning of Money, London, 1910, p. 38.*

The Second Greatest Story Ever Told

Chapter One

(in which the gentle reader learns about the miracle of one gold coin performing the job of three)

The cotton dealer shipped cotton to the spinner and billed him for goods received. The spinner 'accepted' the bill, that is, he acknowledged receipt of goods by writing across the face of the bill 'I accept' over his signature. This signified his acceptance of the responsibility to pay the face value of the obligation at maturity. He then returned the bill to the cotton dealer pending settlement in coins.

Having spun the cotton, the spinner shipped the yarn to the weaver and billed him. The weaver accepted the bill and returned it to the spinner pending settlement in coins.

Having woven the yarn, the weaver shipped the cloth to the clothier and billed him. The clothier accepted the bill and returned it to the weaver pending settlement in coins. The journey of the same cotton on its way to the consumer has spawned three separate bills, each held by a particular supplier, pending settlement at maturity. Now the clothier had cash-paying customers, the ultimate consumers of cloth. After the cloth was sold, he had the gold coin given up by the consumer. When the bill drawn on him matured, and the weaver presented it to him for payment, the clothier passed on the gold coin of the consumer. After adjustment was made in small change for the difference in the face value of the bill and that of the gold coin, the weaver-on-clothier bill was marked 'paid'.

Soon afterwards, the spinner presented his bill to the weaver for payment who paid it by passing along the gold coin of the consumer. After adjustment in small change, the spinner-on-weaver bill was marked 'paid' by the spinner.

Finally, the cotton dealer presented his bill to the spinner for payment, who paid it by passing along the same gold coin of the consumer. After adjustment in small change, the dealer-on-spinner bill was marked 'paid' by the dealer. The cycle of supplying the consumer with cloth was complete. In the end, no one owed anybody anything.

The remarkable feature of this primitive clearing system is that the use of bills has increased the efficiency of the gold coin four-fold. In the absence of bills

the pool of circulating gold coins would have had to be invaded and drawn upon four times in order to move cotton to the ultimate consumer. As it happened, the pool of gold coins wasn't invaded even once. The single gold coin of the consumer given up in exchange for the finished cloth was sufficient to extinguish all the claims arising along the journey of the cotton from the dealer to the consumer. It is also clear that, regardless how roundabout the journey of the cotton may, due to further division of labor, become in the future, the single gold coin of the consumer will always be sufficient to extinguish all the claims arising along the cotton's journey. To put the matter differently, the gold standard is no longer a fetter upon technological progress and further division of labor, as it would be in the absence of the bill of exchange. The number of hands engaged in the movement of cotton to the ultimate consumer can increase from four to fourteen, and later to forty if necessary, without adding any new demand for additional gold coins. The lengthening of the production and distribution process, of course, represents specialization, improved technology, better tools, cost reduction, in one word: greater efficiency. The bill of exchange has opened up new avenues for progress, leading to great improvements in the condition of human life on earth. Technological progress will never again be obstructed by a dearth of gold.

Time is obviously a factor in the cycle of supplying the consumer with cloth. We may assume that the journey of cotton from the dealer's warehouse to the consumer takes, on the average, three months to complete and, accordingly, the dealer-on-spinner bill is drawn to mature in 3 months. The journey of yarn from the spinner to the consumer takes two months to complete and, accordingly, the spinner-on-weaver bill is drawn to mature in 2 months. Finally, the journey of cloth from the weaver to the consumer takes one month to complete and, accordingly, the weaver-on-clothier bill is drawn to mature in 1 month. In this way, although the three bills have different life-spans, they will all mature on the same day, facilitating settlement.

Chapter Two

(in which the gentle reader learns about an innovation enabling the consumer to choose from a variety of cloth three times as great as before, without it costing anybody a penny)

One day the clothier told the weaver that he would be glad to carry an inventory of cloth three times as large, in order to enable his customers to select from a greater variety of cloth. Naturally, the weaver was delighted with the proposal, and agreed to draw 3-month bills on the clothier instead of 1-month bills as before, since an inventory 3 times as large may take 3 times longer to clear. Now the weaver needed different types of yarn to weave a greater variety of cloth. He figured that he could use half again as much yarn as before. His new inventory of yarn, being 1 and 2 times larger, may take 1 and 2 times longer to clear. Accordingly, the spinner agreed to draw 3-month bills on the weaver, instead of 2-month bills as before. In his turn, the spinner need not keep a larger inventory of cotton on hand because all yarn was coming out of the same bale.

Now all three merchants: the cotton dealer, the spinner, and the weaver were drawing bills not only with the same maturity date, but also with the same life-span of 3 months. The new system worked very well indeed. New supplies were ordered, and bills drawn on them matured monthly, instead of quarterly as before. Consequently, adjustments to the changing taste of the consumer could be made more readily. The clothier had no plans to enlarge his inventory of cloth any further, and had no reason to request the weaver to extend the maturity date of his bills beyond three months.

At any rate, the weaver would have had solid grounds to resist such a request. If the cloth moved faster due to brisker consumer demand, the adjustment would have to be made, not through the size of inventory, but through that of the monthly shipments. Three months (or 13 weeks, or 91 days) is just the length of the seasons. If the clothier could not sell a certain kind of cloth in 91 days, then he might not be able to sell it for 365 days, before the same season of the year came around once more. However, by that time fashion could change beyond recognition, and the clothier might not be able to sell the cloth out of vogue except at a loss. For this reason, there is an unacceptable risk involved in drawing bills of exchange with maturity 92 days or longer. A slow inventory of cloth that may take more than 3 months to sell cannot be financed through clearing. Its journey to the consumer must be financed through borrowing. A bill of exchange must always represent merchandise that moves, and

move it must fast enough so that the shelves in the retail store can be cleared once every quarter.

Chapter Three

(in which the gentle reader learns about another invention: that of making one bill do the job of three. The drawer of the bill is making his first tentative steps to put the bill into circulation "a small step for one man, but a giant step for mankind")

Some time later our tradesmen met in a pub, and over a pint of beer discussed the success in financing the production and distribution of their merchandise through real bills, as well as a new proposal of the clothier to simplify their billing further. The clothier pointed out that one bill could in fact do the work of all three, as the title to the proceeds could easily be transferred to the next holder by endorsing. "At the end of the first month the weaver will endorse the bill", the clothier explained, "and pass it on to the spinner in payment for the yarn, after the necessary adjustment in the outstanding amounts is made in small change". The weaver got the point and added: "At the end of the second month the spinner, after endorsing the very same bill, will pass it on to the cotton dealer in payment for the cotton, not forgetting to make the adjustment in small change for the difference in the outstanding amounts". The spinner also chimed in: "And at the end of the third month the bill will mature. The cotton dealer can collect his receivables". The spinner raised his glass and, turning to the clothier continued: "And you, my friend, will have the gold coin to pay him! By that time the entire inventory of cloth will have been sold for gold coins. I salute you for your brilliant idea of turning the bill into currency!"

The tradesmen were enthusiastic. The experiment came through with the flying colors. This was a veritable breakthrough. The physical movement of the gold coin was reduced to its irreducible minimum - without any loss of mobility of goods. The payment of gold by the clothier to the cotton dealer, as it were, 'telescoped' the three payments occasioned by the movement of cotton from the producer to the consumer into one. The economy in the movement of gold was achieved by giving temporary monetary privileges to the bill drawn on the clothier. The weaver-on-clothier bill could henceforth 'circulate' before its maturity date. It was readily accepted by the spinner and the cotton dealer in payment, neither of whom was a party to the deal which formed the basis for drawing it. The significance of this discovery could hardly

be exaggerated. Credit could now circulate among the tradesmen on the same terms as gold without a hitch. It was also clear that this circulation owed its existence to the movement of the underlying merchandise. The emphasis is on the word 'movement'. The clothier experimented with bills representing stalled merchandise (left unsold from the previous season). He found, to his great regret, that these bills just would not fly.

Of the three, it was the weaver-on-clothier bill that was at the head of the line waiting to be exchanged for the gold coin of the consumer. To use the technical term we say that it was "more liquid" than the others as it could circulate in lieu of cash. The other bills, being less liquid, fell by the wayside. There was no need to draw them any more as the endorsement of the weaver-on-clothier bill was considered payment in cash.

A finished good ready to be sold to the consumer is called a *first order good*. There are also *higher order goods*. An n-th order good is a semi-finished good that is n times removed from the consumer, e.g., the cloth is a 1st, the yarn is a 2nd, and the cotton is a 3rd order good. The acceptor of the bill (in our example, the clothier) is the retail merchant selling the first order good to the consumer, to whom the drawer of the bill (in our example, the weaver) is supplying the first order good. The same bill, after the n-th endorsement, is used to pay for the supply of the (n + 1)-st order good. We shall call this primitive circulation of bills *vertical*. It is confined to the circle of tradesmen engaged in the production of the same merchandise, where one is the supplier of the other. But as we shall soon see, this limitation is not essential. The circulation of the bill before its maturity date would eventually become universal.

I shall briefly interrupt relating *The Second Greatest Story Ever Told* in order to describe another variety of real bill circulation called *horizontal*.

The Merchants of Seville

This is not the title of an opera, nor that of a drama; it refers to one of those great annual medieval fairs which used to attract merchants from very great distances to the fair city such as Leipzig in Germany, Lyon in France, and Seville in Spain, located at the crossroads of great trading routes. The fair itself could last a month or even six weeks. Some of the merchants came from as far as a thousand miles

away. All of them came to sell home-produced wares as well as to buy the wares of other regions that could lie another thousand miles away from the fair city in the opposite direction. We could imagine that it must have been well worth the effort of the merchants to travel and spend all this time so far away from home. This was the way to export and import in those days; there was no other. While they carried home-made merchandise in their carriages, one thing they did not carry with them. They did not carry gold. They expected to make their purchases with the proceeds of their sale. The trouble with that was that they had to sell first in order to be able to buy afterwards. This was a fatal limitation. It may have meant missed buying opportunities. This trouble was eliminated by the clearing house of the fair which made it possible for the merchants to buy first and sell afterwards, if they so desired, as we shall now see.

The remarkable thing about these medieval fairs was their clearing system. An enormous quantity of goods exchanged hands (some several times) facilitated by a very small pool of gold coins. How did they do it? Just think for the moment, if you will, about the enormous logistical problem they were facing. Barter was pretty well out. They quoted gold prices, but they realized that the buyer they were dealing with, just like themselves, did not carry gold with him. So how could they make the sale if a prospective buyer was willing to pay the price asked?

Well, they developed an ingenious clearing system using bills of exchange maturing on the last day of the fair. Every merchants registered his merchandise at the clearing house upon arrival. Registration gave them the right to accept bills payable at the clearing house where bills would be offset against one another and only the difference in face values would be paid in gold coins on the last day of the fair. This afforded an amazing economy in the use of the gold coin. It was this economy that was responsible for making the fairs so attractive to merchants coming from far-away places.

We may be certain that without the clearing system there would have been no fair, and trade would have been limited to that between next-door neighbors. If merchants traveling those great distances would have had to carry not only their merchandise for sale, but also the gold coins with which to make their purchases, they would not have undertaken the trip. For one thing, they probably would not have had the gold, which was needed for domestic use. For another, on the long trip they would have offered themselves as easy targets for highwaymen preying upon the purse of traveling merchants.

The circulation of bills of exchange generated at the fair may be described as *horizontal*. They were all drawn on first-order goods ready to be sold to the consumer, and they were passed on from hand to hand between retail merchants (rather than from the producer to his supplier, as in the case of *vertical* circulation).

The medieval fairs were a marvelous institution promoting trade between far-away regions. Not enough research has been done on this subject, especially on the inner workings of the clearing and insurance facilities offered at the fairs.

Real Bills Never Cause Inflation

We have seen that real bills may arise in different settings and facilitate exchanges of goods that may not otherwise come about simply because of the limited supply of gold coins available for trade. If people saw that the goods were in sufficiently urgent demand, and ultimate payment was guaranteed by the fact that the underlying goods would be soon (i.e., before the maturity date) removed from the market by the ultimate consumer paying gold coin for his purchase, then they would take the bill (provided it has been duly accepted) in payment and then use it themselves in paying for their own purchases. Thus bills became the preferred currency of the fair.

Detractors of the Real Bill Doctrine maintain that the circulating bill was inflationary in that it meant an expansion of the pool of circulating purchasing media. However, this position is demonstrably wrong. The bill emerged simultaneously with the emergence of new merchandise in urgent demand of the same value, and would disappear from circulation at the same time when the merchandise was sold. The net effect on the stock of purchasing media was therefore zero.

It is helpful to think of the bill of exchange as an instrument that automatically adjusts the stock of purchasing media to the stock of merchandise to be cleared by the markets. During peak season, when the turnover of merchandise reaches its maximum, the means of payments to move it is readily available. Once the merchandise has been removed from the markets, the extra amount of purchasing media disappears. This means that in low season the pool of purchasing media contracts and there is no excess cash chasing non-existent goods. The whole process of adjustment is automatic, and works without direct intervention on the part of the banks or the government. In fact, the whole system of supplying the

consumers with all the goods in high demand through bill circulation will work even in the complete absence of banks.

World Trade Today

Another example of the horizontal circulation is the pre-1914 financing of world trade by drawing bills on London. In this case London acted as the clearing house of a non-stop fair. Merchandise was carried by the merchant navy directly from the exporting to the importing country. The volume of world trade was huge, it was a two-way street, consequently, the pool of gold coins to finance the movement of merchandise was tiny. Yet the system worked beautifully, thanks to the horizontal circulation of self-liquidating commercial paper. The small and relatively stable pool of gold coins in London could finance the huge volume of world trade as it flowed and ebbed with the seasons.

Compare that with world trade today, which has been governed not by commercial, but by political considerations since World War I and, therefore, has been reduced mostly to one-way flows. The chits of the world's greatest military power are used, under duress, by all trading nations of the world. After the chits have done their job of financing trade they keep piling up, also under duress, in foreign central banks. The nations of the world are lulled into the false belief that these monetary reserves are real, usable when the need arises, and earn interest in a meaningful way. But the cruel truth is that they represent the permanent debt of the United States, the largest debtor of the world (it used to be the largest creditor before 1972, the year when the U.S. defaulted on its gold obligations to foreign central banks). It is a pipe dream that the debt of the U.S. plus accrued interest will ever be repaid - certainly not in dollars of the same purchasing power. Take Japan, for example. It could use her enormous dollar reserves it has accumulated over a period of half a century in order to clean up the mess in the Japanese banking system. But while they are may be available to buy a Coca Cola bottling franchise, or use it for the purposes of making small payments to third parties, they are definitely not available for liquidation in larger quantity. It would wreck the bond market, and ruin the credit of the United States government, if Japan insisted on using its monetary reserves to solve its banking crisis. There is simply no way for Japan to liquidate its monetary reserves accumulated under duress.

The United States has dismantled its export industries (with the exception of those of strategic importance) just at the time when it should have expanded exporting capacity in order to service its huge and increasing external debt. It has exported industrial jobs to third world countries in exchange for consumer goods it no longer produces domestically. This means that the trade deficit is to continue, and increase, indefinitely.

The costs of this perverse (not to say insane) system of financing world trade, based as it is on coercion, are enormous. Apart from it causing relentless currency depreciation, the piling up of U.S. government debt in foreign central banks makes overseas holders of dollar balances nervous. For the time being, foreign central banks play the game according to the rules dictated by the U.S. Treasury. They resist the temptation to cash their dollar balances, presumably motivated by thieves' solidarity, that "we had better hang together, lest we hang separately". But when a country breaks ranks and starts liquidating its dollar balances, as is inevitable, all others will run to the exit. The world's monetary system will crash.

Such a crash could never occur under the international gold standard with world trade financed by horizontal bill circulation. Bills of exchange are self-liquidating credit instruments. They cannot pile up in foreign central banks. Once the goods are sold to the ultimate cash-paying consumer, the bills of exchange that financed their trade simply disappears. Why can't the world return to world-trade to a system of payments using horizontal bill circulation? Because such a system must be a gold-based system, and gold is anathema to the United States Treasury.

Yet this system of bill-circulation is well-worth not only studying but also emulating. The big banks of the world from Japan through Germany to the United States are rushing into bankruptcy with break-neck speed. The central banks won't be in the position to bail them out. Their so-called assets, namely U.S. government debt, are strictly for window-dressing purposes. They are useless as a monetary reserve, if you have illusions to liquidate your holdings in order to pay off your own debts.

We may face an epoch in history without banks, a world in which people will refuse to trust bankers and their promises.

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Bravo for Monetary Economics 101!

Malik Yusuf of Edith Cowan University, Perth, Western Australia writes:

Sir,
Bravo for Monetary Economics 101. A standing ovation for each Lecture. Only the Internet made it possible for me to continue my education outside of the recognized institutions. I have started my studies in economics formally at the late age of 38 as a result of my discovery of your work. If the underlying cause for the excesses of this dark age is as you have diagnosed, then I feel that this is where I should begin my studies, even though I must start from scratch. It is a truly fascinating experience to receive one narrative from the official curriculum, and jostle for high grades with the current generation of students being groomed and indoctrinated with the same, and then, after hours, to obtain my real nourishment and hope for the future from studying your material.

Your most ardent pupil,
Malik Yusuf

We are fortunate indeed that, thanks to the Internet, we need no longer be forced into the straitjacket of orthodoxy and subjected to the brain-washing of official indoctrination. In earlier ages universities were the focal points of intellectual dissent, and resistance to an ossified science and culture. No more. Virtually all universities in the world are now in the service pusillanimity, cringing in front of the thought police that discourages and persecutes independent thinking. Let's hope that there will be lots of initiatives like ours to break the thought-monopoly of governments, and let truth be the winner.

Chapter 6

The Invention of Discounting

(Lecture Six)

The Second Greatest Story Ever Told, Chapers 4 to 6 - The Origin of Discount - The Discount Rate and the Rate of Interest -

Why Is This Story Important?

I got several comments from my audience to the effect that the story on the invention of real bills and discounting has only historical interest, and hardly any relevance to contemporary affairs. Actually, if the world is ever to return to a gold standard, we have to understand how it worked in the past. My researches show that economists have not succeeded in explaining its operation. They approached the issue from the position of mercantilism and from that of the Quantity Theory of Money. For example, they explained the adjustment mechanism governing foreign trade in terms of the international gold standard as follows. A country running a trade surplus is gaining gold while another running a deficit is losing it. The money supply of the surplus country grows, and that of the deficit country contracts. Other things being the same, there will be an increase in the price level in the surplus and a decrease in the deficit country. In the absence of trade barriers the surplus country will export less and import more, while the deficit country will export more and import less. This process will continue until the trade surplus/deficit disappears. International gold flows tend to reestablish equilibrium in the foreign trade accounts of gold standard countries, through their effect on the price level. So goes the argument. However, the available trade statistics show that

this was not at all what was happening. International gold flows were negligible, and they were moved by other factors than payment for net imports. In fact, the adjustment mechanism worked not on the relative price levels, but on the discount rates of the trading countries. We must have a new theory of foreign trade, purged from the influence of mercantilism and the Quantity Theory of Money. In these Lectures I intend to develop this new theory of the gold standard in terms of the Real Bills Doctrine. Let us now return to The Second Greatest Story Ever Told.

Chapter Four

(in which the gentle reader learns how discounting was invented)

The weaver-on-clothier bill was singularly well-suited to play the role of means of exchange. The clothier came into daily contact with the gold coin in the course of his business (by contrast, the weaver and the spinner didn't see much gold in the pursuit of their trade). Often the clothier found himself in the position that he could prepay the bills he has accepted, sometimes well before maturity. But our clothier was a very shrewd man, with a perfect grasp of the reality that moved merchandise in one while moving bills in the opposite direction. The clothier would prepay the bills he has accepted only *for a* consideration. *In more details, whenever people asked him to prepay a bill before maturity, as the weaver often did, he would offer to* discount it, *that is, to apply a reduction to the face value of the bill proportional to the number of days left to maturity. The weaver didn't object to receiving less than the face value of the bill. He needed ready cash, and he could not get it on any better terms than discounting his bills with the clothier. For his part, the clothier wanted the custom of the weaver as an obvious supplier of bills for his budding discount business, so he would offer the best terms to him he could. The discount was an income for him that the gold coins in his till could not otherwise generate. Clearly, both parties benefited from discounting. After this latest innovation people no longer talked about* paying *a bill; they talked about* discounting it.

The origin of discount is merchant custom. The sale of cloth by the weaver to the clothier is not final until the bill is marked 'paid'. The cloth is on consignment. Payment at maturity is subject to the sale of cloth to the ultimate, cash-paying customer. Payment before maturity is certainly not a matter of right; it is a matter for negotiation. The height of discount depends on the intensity of consumer demand as

observed by the acceptor of the bill. If the demand is brisk, he will be satisfied with a smaller discount. But if the demand is slack, then the acceptor who still has an unsold inventory on hand to worry about - which he will, after discounting, carry entirely at his own risk - must insist on a larger discount. He wants to be compensated for the increased risk of carrying inventory that he may not be able to sell except at a loss.

Soon enough the clothier started posting his discount rate, that is, the amount of discount in cents, per $\$100$ *face value per day. For example, if the discount rate is* $4¢$*, then a bill of face value* $\$1500$ *maturing in* 50 *days will be discounted to* $\$1500 - 15 \times 50 \times 4¢ = \$1500 - \$30 = \$1470$ *since* $\$1500 = 15 \times \$100$*. The clothier reserved the right to adjust his posted discount rate, every day if need be, to reflect the changing mood of the consumer.*

No Lending Is Involved in Discounting

It was a later development that an annualized discount rate became the norm of quoting it (even though the credit involved would never ever exceed 91 days). For example, if the bill with $\$100$ face value had 91 days to run to maturity, and was discounted to $\$99.50$, then the discount rate was 2% per annum.

Indeed, 4×91 days $= 1$ year, therefore, on an annualized basis, the discount is $4 \times (100 - 99.50) = 4 \times \frac{1}{2} = 2$ percent.

The fact that the discount rate is quoted on an annualized basis, the same as the rate of interest (in spite of the fact that the bill will mature long before a year would go by) has led to a curious mistake that was not free from its more ominous consequences. It has been suggested that discounting a bill is just another way of making a short-term loan, and the discount is nothing more or less than interest on the sum to be loaned, taken out of the loan in advance. In this (erroneous) view the discount rate is just another name for the short-term rate of interest. It would follow that there are no new problems here to study: in this (erroneous) view the source of discount rate is the same as that of the rate of interest, namely time preference (or its reciprocal, the *propensity* to save).

This was one of the most damaging mistakes ever made by economic theoreticians. In fact, *there is no lending and borrowing involved in the act of discounting.* The clothier is not lending and the weaver is not borrowing (nor is the clothier retiring a loan owed to the weaver) when the former discounts the bill before maturity for the latter. The discount rate has nothing to do with time preference (or

its reciprocal, the propensity to save). It has everything to do with the propensity to consume (or its reciprocal, the productivity of the Social Circulating Capital, a concept I plan to introduce in a later course).

All participants of the bill market take to heart the admonition of Polonius to his son, Laertes:

> *Neither a borrower, nor a lender be,*
> *For loan oft loses both itself and friend,*
> *And borrowing dulls the edge of husbandry.*
> *– Shakespeaere* [1]

Shakespeare may sound hopelessly outmoded to our ears in the 21st century. Yet it is quite possible that he saw something that most others have failed to see. The advice of Polonius is not meant for everybody. If there is a lesson to be learned from the endless disputes about usury, usurers, and about the advantages or disadvantages of lending or borrowing, then it must be this. To make or take a loan is an art that cannot be profitably cultivated just by anybody. This art, no less than any other, has to be learned, practiced, refined, and rehearsed by both the lender and the borrower, each on his own turf. Implicit in Shakespeare's line is the fact that not every form of credit may involve a loan, lending and borrowing. It is precisely that form of credit we are studying here, that arises through clearing, epitomized by bill circulation and discounting, that ought to be available to everyone - whether one is artistically inclined or not.

Indeed, credit can and does arise independently of lending and borrowing. When the weaver draws a bill on the clothier, he is extending credit, yet he is *not* a lender and the clothier is *not* a borrower. Nor should the transaction consummated be regarded as a loan. The perception that the drawer grants a loan to the acceptor when he delivers goods against payment in the form of the bill accepted, or the perception that the acceptor repays the loan to the drawer when he discounts the same bill before it matures, is entirely fallacious and must be resisted by all means. *The credit is an integral part of the deal, by virtue of the momentum of the underlying merchandise moving apac*e. By standard merchant custom, the terms "91 days net" are part of every such commercial deal. Stated otherwise, prices quoted by the wholesaler to the retailer are *discountable* prices. The amount of discount depends

[1] *Shakespeare, Hamlet, Act I., Scene 3.*

on the number of days the credit is used, and on the discount rate prevailing at the time of payment.

The Discount Rate Is Independent of the Interest Rate

Time preference, that determines the rate of interest, has nothing to do with the discount rate. Discounting is not governed by the *sovereign saver*. It is governed by the *sovereign consumer*. As we have seen, it is the consumer's slacker or brisker buying that makes the discount rate rise or fall. We express this by saying that *the discount rate varies inversely with the propensity to consume*. (By contrast, the rate of interest varies inversely with the propensity to save.) The conceptual difference between the two rates was observed by John Fullarton[2] writing in his book *On the Regulation of Currencies* as follows:

> *"It is a great error indeed to imagine that the demand for… the loan of capital is identical with a demand for additional means of circulation, or even that the two are frequently associated. Each demand originates in circumstances peculiarly affecting itself, and very distinct from the other. It is when everything looks prosperous, when wages are high, prices are on the rise, and factories are busy, that an additional supply of currency is usually required… whereas it is chiefly in a more advanced stage of the commercial cycle, when difficulties begin to present themselves, when markets are overstocked, and returns delayed, that interest rises, and pressure comes on the bank for advances of capital",*
> *(op. cit., p. 97).*

The confusion between the discount rate and the rate of interest has also been noted by Charles Rist[3] in his *History of Money and Credit Theory from John Law to the Present Day*:

> *"Identification of the discount rate with the interest rate, which is frequent among English writers, is an unfortunate source of confusion",*
> *(op. cit., p. 315).*

[2] *John Fullarton, On the Regulation of Currencies (originally published in 1844), NY: A.M. Kelley, 1969.*
[3] *Charles Rist, History of Money and Credit Theory from John Law to the Present Day, 1940.*

Achillean Heel of the Quantity Theory

The idea that the bill of exchange can circulate on its own wings and under its own power is often ridiculed by advocates of the Quantity Theory of Money, as I have pointed out in Lecture 3. The vicious attacks of monetarists, including those of their high priest Milton Friedman, on the Real Bills Doctrine mark the Achillean heel of the Quantity Theory of Money. It shows that an increase in the quantity of purchasing media need not cause a rise in prices. If the new purchasing media emerges simultaneously with the new merchandise, and the two disappear together as the latter is removed from the market by the ultimate cash-paying consumer, as in the case of financing the production and distribution of consumer goods by bills of exchange, *there will be no price rises on account of the increase in bill circulation.*

Detractors of the Real Bill Doctrine argue that several bills can be drawn on the same merchandise on its way to the market. So they can. But as I have pointed out in the previous Lecture, only the most liquid one, the bill drawn by the supplier on the seller of *first order goods* will be put into circulation. Just what the order of the underlying good is should be clear from the information provided on the face of the bill. If an additional bill on the same good is put into circulation, then, clearly, fraud is involved. It is disingenuous to attack a theory arguing that it fails whenever fraud is present. On that basis, every theory can be dismissed as worthless.

Demand for Real Bills

We have seen that the spinner and the cotton dealer were happy to hold the weaver-on-clothier bill to maturity. As soon as discounting became a universal practice, the demand for these bills has greatly increased. Other tradesmen also found it to their advantage to hold the bills to maturity. They looked at bills as a unique instrument combining two seemingly contradictory features: (1) that of an earning asset, (2) that of a medium of exchange. In fact, bills provided the only way to generate an income on cash holdings. Usually an earning asset is illiquid in that it takes time and, sometimes, monetary losses to liquidate them in a hurry. With the appearance of discounting this has changed. Now tradesmen could earn an income on that part of their circulating capital which they had to carry in the form

of cash. As most businesses were cyclical in nature, they had to face a fluctuation in their cash needs. It was a most welcome development that they could generate an income on their cash holdings especially at the time they were entering their slow season.

In the next Chapter of The Second Greatest Story Ever Told we shall see how the demand for real bills snowballed as people discovered their great versatility.

Chapter Five

(in which the gentle reader learns how the wily clothier shifted his cross of gold onto the shoulders of the miller)

One day the weaver's loom broke down and was found beyond repair. The weaver had to get a new loom in a hurry. He did not have the ready cash, but he had a pile of maturing bills drawn on and accepted by the clothier. He visited his colleague and offered him the bills at a good discount. The clothier was anxious to help. An interruption in the supply of cloth would hurt his business, too. But he could not come up with the necessary sum in gold. However, as we have said, the clothier was a very smart man, and his advice was worth gold. "Why don't you offer these bills to the loom-maker in payment for the new loom?" the clothier suggested. "If the spinner found them attractive to carry to maturity, so should the loom-maker."

As predicted, the loom-maker was happy to take the weaver-on-clothier bills. He looked at these bills as a liquid earning asset which could be passed on easily if the need arose. The weaver found the discount rate offered by the loom-maker acceptable. He endorsed the bills, thus transferring the title to the proceeds to the loom-maker. Once more, there was no interruption in the business of satisfying consumer demand due to a shortage of gold coins. The versatility of the bill of exchange drawn on consumer goods in demand, and its potential for circulation, was proved again. The weaver-on-clothier bill could circulate even outside the small circle of tradesmen engaged in the production of cloth.

As it happened, next morning the clothier had a field day selling out his entire inventory of cloth. As his till was now flush with gold coins, he thought that his cash could with advantage be put to some use. He recalled that the previous day the weaver was offering his bills for discounting. So he emptied the contents of his till into a large purse, and walked over to the weaver's. There to his chagrin he found that his

earlier advice to the weaver was 'too good'. The weaver told him that he had passed on all the weaver-on-clothier bills to the loom-maker. Since the clothier felt uneasy with that much gold on hand, he decided to walk over to the loom-maker and offered to discount the bills he had come into the possession of earlier. But the loom-maker had disappointing news, too. He had in the meantime passed on those bills to the bricklayer in payment for work on the extension to his loom-factory. "If you hurry you might catch him, he left the premises scarcely an hour ago".

The clothier was annoyed. He wasn't going to run after the bricklayer. He saw that he could only blame himself. Here he was, foolishly chasing his own bills. "And they call this division of labor", he fumed, looking at the heavy purse of gold he grew tired of carrying. "Someone ought to do something about it, and let me mind my own business!"

Luckily, the flour mill was next door to the loom factory. The clothier got an idea. "I shall be damned if I ever go on wild goose chase again", he said to himself. "They will surely come home to roost, on their own wings, in their own good time - and so will my bills!" He dropped in to see the miller, asking him whether he wanted to get rid of some of the miller-on-baker bills in his possession. "I just thought you need a few extra gold coins. You must be buying grain to fill up your bins. It's harvest time."

As far as the miller was concerned, it was a deal. They didn't quibble long about the discount rate. The clothier let out a sigh of relief as he exchanged his gold coins for the bills endorsed by the miller. "It is high time, too", he said to the miller and added, jokingly: "I got tired of carrying my heavy cross of gold. It is your turn now, to take up the burden."

The clothier was pleased with himself. He was the type of man who would always turn adversity into advantage, by looking for a moral. Just as he thought: he had no trouble, after all, unloading his 'cross of gold'. There were always willing takers around.

The fact that the loom-maker and the bricklayer were happy to take the weaver-on-clothier bills in payment was a very significant discovery indeed. It proved that maturing bills of exchange on merchandise in great demand were perfectly acceptable as purchasing medium. Whoever got the bills had no doubts that he could also pass them on without difficulty, should he have to make an unexpected payment before the bills have matured. And if he kept the bills, he would earn a welcome return on his cash holdings.

While the bill of exchange was a good substitute for the gold coin, it was not a 'perfect' substitute, as the baker found out when he offered weaver-on-clothier bills

in his possession to the grain merchant when the miller-on-baker bills came up for payment. "Don't take me for a fool!" the grain merchant told the baker angrily. "This paper clearly calls for payment in gold, and not in another piece of paper! If you haven't got gold, then you are in violation of your contract!"

The grain-merchant was right. At maturity the miller-on-baker bill must be settled in gold. The idea of settling paper with more paper suggests fraud. A bill that at maturity can only be paid by drawing another stinks. The bill of exchange *must* be settled in specie at maturity. How otherwise could the holder of the bill be sure that he wasn't being taken for a ride? This reveals a function of the gold coin in which no other means of payment can deputize for it: gold is the philosopher's stone, the only one with which the quality of outstanding credit can be gaged. (In future Lectures we shall see other instances where the gold coin cannot be substituted by paper currency.)

Social Circulating Capital

In Lecture 4 I introduced Adam Smith's concept of the Social Circulating Capital. It can be visualized as that mass of goods that society is appropriating strictly for the purpose of imminent consumption during the next 91 day period. This mass of goods is far from being static. It is dynamic in the sense that its size and composition is changing constantly, following the proverbially fickle demand of the consuming public. I also proved the theorem that an item belongs to the Social Circulating Capital if the bill drawn on it will circulate - or, using our new term just introduced, if the bill can be discounted; if not, then the underlying item does not belong to the Social Circulating Capital. In the next Chapter we shall see that the unique quality of a good to belong to the Social Circulating Capital has to do with the drastic reduction in uncertainty concerning the path that good will follow as it is moved closer to the ultimate consumer. The risks of tradesmen in moving that good have been reduced to their irreducible minimum.

Chapter Six

(in which the gentle reader learns why cloth can, but bricks cannot, fly)

It was the beginning of winter when somebody was knocking at the weaver's door. It was the bricklayer. He recalled that in the summer he had held some weaver-on-clothier bills the loom-maker gave him in payment for work done. This time he wanted to get it right from the source. He has brought the gold coins along to save the weaver the trouble of carrying them himself.

The bricklayer was trying hard to please the weaver. His business was rather slow in the winter, and he wanted to earn an income on his idle cash. He looked at the bill of exchange as an appreciating asset: every day it was worth more, right up to the day of maturity. By its very nature, the bricklayer's own trade did not generate any bills of exchange. His bills could never hope to circulate. Money sunk into brick and mortar was not the same as money put into fast-moving goods such as cotton, or wheat, within earshot of the cash-paying consumer.

The bricklayer was not jealous. He understood perfectly well that the preferential treatment given to theweaver-on-clothier and miller-on-baker bills, but not to the brickyard-on-bricklayer bills, was bestowed by the market for a good reason. The discrimination had to do with the nature of the underlying merchandise, and had nothing to do with character or personal honor. Brick is not consumed in the same way as cloth. It is used in building houses which are not bought and sold against cash payments representing the full purchase price. Therefore the production and distribution of bricks is financed quite differently from that of cloth. The fast movement of cloth to the consumer can generate bill circulation; the much slower movement of brick cannot. The movement of bricks to the consumer must be financed through lending and borrowing.

The weaver was pleased to comply with the request of the bricklayer. He even took a standing order for weaver-on-clothier bills to cover the winter months when the construction business was slow and the bricklayer needed a safe and profitable place to park his circulating capital idled temporarily.

It is crucial to understand the economic difference between cotton and brick. Cotton had the momentum which brick lacked. The financing of the movement of cotton could be done through bill-circulation. The financing of the movement

of bricks couldn't: the brickyard-on-bricklayer bills could not fly for lack of momentum in the movement of bricks. The slower movement of bricks had to be financed through lending and borrowing, at the higher interest rate. This involved convincing the lender (saver) that the ultimate consumer of bricks, the buyer of the house, did have the means to retire the mortgage on his new house in time. As the proverb says, "there is many a slip between cup and lip". In case of the cloth (or any other item belonging to the Social Circulating Capital) the lip is already touching the cup and, accordingly, the chance of a slip is reduced next to naught.

A bill acknowledging receipt by the retailer of fast-moving merchandise can circulate in lieu of cash. The market extends limited and ephemeral monetary privileges to bills representing certain transactions while denying the same privileges to others. The decision whether to extend or deny it depends on objective criteria, having to do with the briskness of consumer demand, as well as the time-frame within which 'maturing' goods can be moved to the cash-paying consumer. Goods that are disqualified (as bills drawn on them would not circulate) are not left out in the cold. Their movement to the consumer is financed through lending and borrowing, at the higher interest rate. For example, the bill drawn on bricks being moved to the construction site will not circulate. Nobody who wants to park his liquid funds in quick earning assets would discount them for lack of liquidity. On the other hand, there are a lot of mortgage brokers who will be happy to arrange the financing for the purchase of bricks connected with the construction of a house. Other lenders would be happy to finance the construction and the operation of the brickyard at the going rate of interest.

In the 18th century there was a saying (long since forgotten) in Lombard Street in the financial district of London: "Nothing is easier than a banker's job, provided that the banker is able to tell a bill and a mortgage apart."

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Rothbard on the Origin of the Bank Note

My correspondent Robert writes: "I have enjoyed your articles on gold-eagle.com. Good job! Keep up the good work! For the last three years I have been teaching economics myself. I started out by reading about the various schools of economics and finally happened upon one that resonated with what I understood intuitively which was, of course, the Austrian School. So for a few years now, in my spare time, I have been reading all I can absorb from the great authors of that tradition. So, as I was reading your installment of Monetary Economics 101 I noticed that you criticized Murry Rothbard's explanation (I don't know who he derived it from) of the evolution of paper currency from warehouse receipts. I actually questioned this as well when first reading his explanations, so I am wondering if you have a list of books you might recommend for learning more on the history of real bills. Also I'm curious what other criticism you have of Rothbard's work or on the Austrian School's in general."

Here is my reply: Stay tuned, Robert, there is lots more criticism to come whence this has come from. Although the Austrians are not monolithic, neither are they sufficiently hospitable to authors who are unable to reduce themselves to sycophancy and to tone down criticism of Austrian idols. Austrian journals never published my contributions, presumably for this very reason.

In addition to my criticism of Rothbard's diagnosis of the fraud in the origin of the bank note and of fractional reserve banking, I shall also criticize his proposed therapy of the malady, 100 percent gold reserve banking. It would never work. It would be unable to supply the elastic currency that the economy needs. It would open the gold standard to even more violent attacks for being 'contractionist' and anti-labor. It is based on a serious misunderstanding of the operation of the gold standard. At any rate, the issue cannot be decided until one has studied the Real Bills Doctrine in depth.

An Austrian by birth although not by affiliation, Joseph A. Schumpeter[4] wrote a concise *History of Economic Analysis*. Chapter 7 on Money, Credit, and Cycles will give you reference to authors who wrote on the bill of exchange. See in particular the debate preceding Peel's Act of 1844 in Britain, p. 695 and p. 725, and his discussion of the Real Bills Doctrine starting on p. 729.

[4] *Joseph A. Schumpeter, History of Economic Analysis, New York, 1954.*

Chapter 7

The Mystery of the Discount Rate

(Lecture Seven)

The Second Great Story Ever Told, Chapters 7 and 8 - One Discount Rate or Many? - Arbitrage - The Rise and Fall of the Discount House -

One Discount Rate or Many?

In the previous Lecture I explained how discounting bills of exchange was invented, how the discount rate appeared, and how changes in the propensity to consume made it go up or down. I also presented the important argument that the discount rate is entirely different in origin and nature from the rate of interest.

We still have one mystery to solve, namely the question: Is there one discount rate or are there many discount rates? Is the clothier discounting at one rate and the baker at another, or are all retailers discounting at the same rate? The next Chapter in The Greatest Story Ever Told will answer that problem.

Chapter Seven

(in which the gentle reader learns why the baker discounts at the same rate as the clothier)

The clothier noticed that his success in trading bills of exchange attracted imitators. The miller was also drawing bills on the baker and used them to pay the grain

merchant for the wheat, after the bill was accepted by the baker. In holding the miller-on-baker bill the grain merchant was earning an income on his idle cash, just as the spinner, holding the weaver-on-clothier bill, was earning an income on his. Both men knew that they could use their bills to pay their suppliers, or anyone else for that matter. They were also confident that if they ever needed gold coins for any reason, they could get them by discounting their bills with another merchant experiencing a temporary overflow of cash.

The clothier had a penchant for inquiry. He was anxious to find out at what rate the baker was discounting the miller's bills. Was it the same rate he was using himself, or a higher/lower rate? To his amazement he found that the baker was discounting at exactly the same rate. Whenever he had reason to change the discount rate, so had the baker, moreover, the adjustment was by the same amount and in the same direction. As there was no collusion, it appeared to the clothier that an 'invisible hand' was guiding them and made the adjustment every time a deviation between their respective discount rates was in the offing. The clothier was fascinated by his discovery and was determined to get to the bottom of it.

It came to pass that the summer was unusually dry and it did great damage to the cotton crop while actually helping the wheat harvest. The clothier noticed that his suppliers were anxious to discount their bills, in spite of the higher discount rate he was posting. They would rather take the gold coin instead of holding the bill. Meanwhile the discount rate posted by the baker actually went down. The clothier's reaction was immediate and dramatic: he sold all the miller-on-baker bills in his portfolio and used the proceeds to buy back all the weaver-on-clothier bills that were still floating out there. He reasoned that the discrepancy between the discount rates must disappear by the maturity date at the latest, and he could pick up some riskless profits by the maneuver of getting out of bills discounted at the lower and getting into bills discounted at the higher discount rate. In other words, the clothier sold bills at the higher and bought them at the lower price, and expected to profit from the equalization of the discount rates.

The weaver was following these maneuvers of the clothier with fascination, and offered a bet. He was betting that the price of bread would go down as a result of the good wheat harvest, and the price of cloth would go up as a result of the disastrous cotton crop. His thinking was conditioned by 'conventional wisdom' asserting that a good crop means lower and a bad one means higher prices. The clothier won the bet hands down. There was no change in the price of the bread, nor in the price of cloth. Moreover, the spread between the two discount rates completely disappeared.

The clothier would not kid himself that all this was due to his intervention in the bill market. He was candid enough to admit that other factors were at work, too. Cotton merchants from other regions not affected by the dry summer were attracted by the higher discount rate. They drew bills against their shipments of cotton to the area afflicted by the drought. Meanwhile, merchants back home were drawing bills against their shipment of grain to other places with a poor grain harvest, where the discount rate was higher. These operations called 'arbitrage' had the effect of equalizing the discount rates on cloth and bread. They also explained why there was no rise in the price of cloth, nor a fall in the price of bread. The spread in the discount rate attracted cotton to the area of shortages, and expelled grain from the area of surpluses. The reason for price changes disappeared before they could materialize.

Arbitrage

The clothier deserved to win the bet since he had the better grasp of the fundamentals of bill trading. The weaver failed to understand that a discrepancy between the discount rates on cloth and on bread is an aberration that was bound to disappear in short order due to the arbitrage of those who understood the bill-trading process. *Arbitrage* means buying in one market while selling in another (the two markets may also be the same as a special case) motivated by the arbitrageur's expectation of a certain change in the spread. The *spread* is defined as the difference between prices at which he has bought and sold. In our example, the weaver-on-clothier bill was bought at a lower and the miller-on-baker bill was sold at a higher price (due to a higher discount rate on the former and a lower one on the latter). By maturity the prices, on average, would be equalized. The arbitrage opportunity of which the clothier availed himself promised him risk-free profits.

Economists haven't paid sufficient attention to the spread and arbitrage, concentrating their efforts on the price and speculation instead. Yet the fact is that arbitrage and speculation are diametrically opposed to one another. The speculator takes large risks in the hope of large profits. The arbitrageur is not interested in increasing risks: he is interested in reducing them. The fact is that the price is subject to so much diverse and capricious influence that predicting its changes is a risky business. By contrast, spreads filter out a good many of these capricious effects on individual prices. Well-informed businessmen know this and, with a solid understanding of the economic factors they can spot the spreads that are out

of line and predict in which direction they will move. In these Lectures I shall concentrate on the guiding star of business: the spread, and describe arbitrage as the principal form of human action, the tool par *excellence* of successful businessmen who provide the driving force behind the changing economic landscape.

In the previous Chapter we saw several examples of arbitrage, and I am asking you to study each one separately. In addition to buying the weaver-on-clothier bill at the lower, against selling the miller-on-baker bill at the higher price, we also saw that if wheat was cheaper in country A and a more expensive in country B, then the arbitrageur would buy it in A and sell it in B. Also, if the discount rate was higher in A and lower in B, then the arbitrageur would buy the bills drawn on country A (where bills were cheaper) and sell the bills drawn on country B (where bills command a higher price). Arbitrage is the most important tool to reduce risks in economic activity. The previous examples are related to *inter-spatial* arbitrage. Warehousing provides examples for *inter-temporal* arbitrage. Take a grain merchant who buys grain in the fall to fill his grain elevators. His problem is that he will need an exorbitant amount of capital in order to be able to shoulder the risk that the price of his grain in the elevators might drop. He solves the problem by going to the grain futures market where he sells forward an equivalent amount of grain. Using another word, he is *hedging* his inventory of grain in his elevators. As he is selling grain from his elevators, he will lift a matching number of his hedges in the grain futures market. Hedging gives the grain merchant protection against falling grain prices. For losses on grain held in the elevator he is compensated by capital gains on the hedges.

Chapter Eight

(in which the gentle reader learns why the clothier was in such a hurry to go out of the cloth business)

Soon afterwards the clothier sold his store and went out of the cloth business. He had a better idea. He would trade bills drawn by one tradesman on another against shipments of consumer goods. The clothier was in a hurry. He assumed that other clever traders might be planning to do the same thing, and he wanted to get a piece of the action.

With a good grasp of the needs of tradesmen the clothier knew exactly where and when to buy bills, or where and when to sell them. He would buy bills drawn on a tradesman whose business was slack temporarily, but who were about to enter their high season. He would sell bills to tradesmen whose wares were moving pretty fast at the moment, but who were about to enter their slack season. In September he would buy bills drawn on the coal-merchant, and offer bills for sale to the grain merchant. The former was building up an inventory of coal for the coming winter heating season, and bills on coal were relatively cheap. The latter was drawing down his inventory of grain and was looking for liquid earning assets where he could park his idling circulating capital until the next harvest.

The clothier knew from his own experience that the inventory of bills in the portfolio of a retail merchant was complementary to the inventory of merchandise on his shelves. Both were earning assets to the retailer, albeit in a different way. The incomes from the two inventories see-sawed with the seasons. The retailer, while keeping the combined value of the two at about the same level, would let the mix vary with the change of the seasons. In this way the retailer could, with the help of the special bill-trading services offered by the clothier, mitigate or eliminate the seasonal character of his business. He would compensate for the decline of income in his low season by increasing the income from his bill-tradingbill-portfolio consisting of bills drawn on merchants in their high season. Then at the start of his high season he would draw down his inventory of bills and use the proceeds to build up his inventory of merchandise. As his income from the bill portfolio declined, so would his income from the inventory of merchandise increase.

The clothier called his new business the "Discount House". He also offered other special services to his clients, such as collecting the face value of bills at maturity from the acceptor. He was making a market in outstanding bills: he would be ready to buy bills from one client who unexpectedly found himself short of cash, or to sell bills to another who unexpectedly found himself with more cash than he needed for the conduct of his business.

The Role of the Discount House

This is how the Discount House specializing in market-making for bills of exchange was born. It has extended the scope of bill circulation greatly. Of course, bills could circulate in the absence of the Discount House, too, but circulation would

be limited to a small circle of merchants in business contact with one-another, such as the spinner, the weaver and the clothier. Now, with the intermediation of the Discount House, one merchant could buy the bill of another even if he was not personally acquainted with him. He relied on the expertise of the Discount House concerning the security of the paper he was buying. A lot of new businesses sprang up to satisfy the seasonal needs of the consumer which could not formerly prosper as a result of the exorbitant capital costs involved in carrying seasonal merchandise. These capital costs were now drastically reduced, as a result of the expansion of bill circulation, thanks to the operation of the Discount House helping to finance trade in seasonal consumer goods.

It may help us understand the bill market better if we contemplate that the market process in effect gives temporary and ephemeral monetary privileges to the bill of exchange drawn of fast-moving merchandise on its way from the producer and distributor to the consumer, as I have suggested earlier. Indeed, consumer goods circulate, and their circulation is fueled by two of the most important human instincts, survival and recreation. Monetary circulation of consumer goods *in natura* is hardly possible. Bills of exchange make consumer goods circulate by proxy, as it were. There is no risk involved in holding the bill. Payment at maturity is a virtual certainty. The underlying consumer goods are know to exist and to be in demand. Shortages of gold, real or imagined, will not hamper the liquidation of the credit drawn against the movement of consumer goods. At maturity the consumer's gold coin will liquidate not only the liability of the last endorser of the bill, but that of all the previous endorsers as well. This is what makes the credit represented by the bill of exchange self-liquidating.

The Hijacking of the Social Circulating Capital

Compare two scenarios: the first in which the Discount House operates in the absence of a Commercial Bank, and the second the other way round, in more details, the Commercial Bank is the only place where merchants can discount their bills which then become the earning asset of the bank. One might say that the two credit systems are economically equivalent. However, there is a significant difference. Full disclosure is achieved only under the first scenario. Here bills are openly traded: everybody is free to inspect all the bills offered for sale. Fraud is nearly impossible, as traders would quickly spot a bill drawn on a stalled good, or

a higher-order good, or multiple bills drawn on the same merchandise. Nor would it be possible to 'roll over' a bill at maturity. There is transparency, every trade in the credit market is under public scrutiny, and every trader is an umpire who would blow the whistle if he saw an irregularity.

Under the second scenario "banking secrecy" covers up most information that the public should be entitled to have. The portfolio of the commercial bank may shelter a lot of illiquid or slow bills that the Discount House would reject outright, such as bills drawn stalled goods, or on higher order goods, or multiple bills on the same good. At maturity a bill may be redrawn, in other words, the absolute ban on extending maturity beyond 91 days could easily be violated under the cover of secrecy provided by the Commercial Bank. The temptation to cheat would be great.

But perhaps the most important shortcoming of the second scenario is in the perverse perceptions created, making the banker the boss and the tradesmen discounting their bills at the bank merely his clients dependent on his favors. In reality the tradesmen are the boss and should be so perceived, while the banker is their servant. After all, the credit being traded is rooted in the momentum of the consumer goods that the tradesmen are moving to the ultimate cash-paying consumer. The banker's job is not that of *rationing* credit, which is the ruling perception, but that of *clearing it*, shifting it from one tradesman who no longer needs it to another who does in the task of moving merchandise most efficiently from the producer to the consumer.

But it is this perverse world is what we have got. The Discount House has been forced out of business by the Commercial Bank in a *coup*. The latter has preempted the business of the former, taking over and monopolizing its functions. The Social Circulating Capital has been hijacked. Formerly it was under the sole control of the tradesmen moving consumer goods along to the consumer with all deliberate speed. The tradesmen used to recognize only the sovereign consumer. Now they cringe before their new boss, the banker, who in turn does not recognize the sovereign consumer. In this way the tradesmen, like the mythological hero Anteus, have been cut off from their natural source of strength, the Social Circulating Capital. The source of strength of Anteus was Mother Earth, and he had to touch her every so often to replenish his strength during the fight. His enemies, privy to his secret, could cause his downfall by holding him up in the air and wrestling him to death that way. The tradesmen are losing the fight as the monopoly of the Commercial Bank over the Social Circulating Capital has made it impossible for them to raise

credit directly from it. The hijacking of the Social Circulating Capital was a very unfortunate development to which I should have to return in a future Lecture.

Efficiency of the Gold Coin

The bill market has made the gold coin extremely efficient, far beyond its physical capability to circulate. The limitation on improvements in production and distribution technology through refining division of labor further has been removed. The bill market has made the monetary system more elastic and more responsive to the needs of the consumer. Any type of good can generate bill circulation, provided that the consumer demands it urgently enough. By the same token, bills representing goods that have just fallen out of the consumers' favor are immediately demonetized. As the bill market works only with short maturities (never ever exceeding 91 days) it will adapt itself quickly and smoothly to the changing whims of the consumer. The bill market is characterized by its near-perfect flexibility, adaptability, and elasticity. Consumer prices no longer depend on the greater or lesser availability of gold coins. If the consumer demands an item sufficiently urgently, then its production and distribution can be financed instantaneously through drawing bills against its movement. The volume of bills flows and ebbs with the volume of merchandise trade, eliminating both price squeezes and price explosions.

The principle of granting certain limited and ephemeral monetary privileges to the bill of exchange is a sound one. It recognizes the fact that a market relying solely on the circulating gold coin could not handle the extra, unexpected, or changing burden that might be thrown upon it by the proverbially erratic behavior of the consumer. Thanks to the flexibility of bill circulation, it is the consumer, and the consumer alone, who ultimately decides what ought to be produced, when, and how much. In the market every day is balloting day. The consumer's ballot paper is made of gold. He casts his ballot by plunking down the gold coin on the retail counter. The distributors and producers of merchandise in whose favor he has cast his ballot, no less than the others he chose not to favor, will certainly get the message.

It is very important for you to see that it is not the *price-system that communicates this message from the consumer to the producer*. Temporary changes in the demand for staple consumer goods (such as food, clothes, fuel) does not give occasion to

changes in the price. The price-system in and of itself is neither sensitive nor quick enough to accomplish the task of alerting the merchants to the impending changes in the mood of the consumer. The message concerning changes in the propensity to consume is communicated to the distributors and producers, not through changing prices, but through changes in the discount rate (and the composition of the social circulating capital, as I shall explain it in a later Lecture). Changes in the discount rate respond quickly and sensitively to the changes in consumer demand. The lubricating mechanism that guards the movement of goods against seizing up when changing to high or low gear is the bill market. Without it, roundabout production processes (making the evolution of goods of ever-higher order possible) could not exist. Without it, the internal communication system of the economy would be overloaded.

Mises on Fiduciary Credit

As I have suggested in earlier Lectures, my presentation of the evolution of fiduciary currency deviates substantially from that of Ludwig von Mises[1]. It is now time to scrutinize this deviation more closely. Mises divides credit into two large categories, according as the party extending the credit does or does not have to make a 'sacrifice'. So credit belonging to the second category is created 'gratuitously'. Mises calls it fiduciary credit, while calling the currency to which it gives rise fiduciary currency.

Mises admits that the concept of fiduciary credit may appear "puzzling, even inexplicable; it constitutes a rock on which many an economic theory have come to grief" (*op. cit.*, p. 297). The bank is creating something out of nothing. Mises specifically criticizes the opposite view (ours) suggesting that when the bank discounts a bill, it merely substitutes its own credit which is more negotiable and has a higher recognition value, for credit represented by the bill which is less negotiable and has a lower recognition value. "The fundamental error [in this explanation] lies in its failure to understand the nature of the issue of fiduciary media. When the bank discounts a bill ... it exchanges a present good for a future good ... [T]he issuer creates the present good ... practically out of nothing" (*op. cit.* p. 341).

[1] *Ludwig von Mises, The Theory of Money and Credit, Indianapolis: Liberty Classics, 1980 (first published in 1912).*

Mises doesn't refer to clearing in connection with the emergence of fiduciary credit, although he uses the term 'circulation credit' (*Zirkulationskredit*) as an alternative name for it, as opposed to 'commodity credit' (*Sachkredit*) which is an alternative name for credit of the first category. Nor does Mises raise the possibility of fraud by the bank when it pretends that it has the power to create something out of nothing by extending fiduciary credit. I find it impossible to go along with Mises' view that the bank, or anyone else for that matter, can create present value out of nothing at (nearly) zero cost. There must be a cost born by someone. Those bearing it may not be aware that they are being victimized by the banks, as the prestidigitation is well-hidden by fraud. But there is a cost. The denial of it this is equivalent to asserting that the banks have supernatural powers.

The failure of Mises to distinguish between two types of fiduciary credit, namely, credit emerging as a result of clearing, and credit emerging as a result of fraud, has led him to dismiss Adam Smith's Real Bills Doctrine as a *deus ex machina*. Adam Smith's theory, unlike that of Mises, admits that circulation credit may arise through spontaneous bill circulation even in the complete absence of banks. This makes it plausible that fraud may appear when the banks enter the scene and establish their monopoly of creating fiduciary credit. I can only speculate that the aversion of Mises to the Real Bills Doctrine was due to his unconditional adherence to the Quantity Theory of Money. At any rate, this unfortunate aversion led Mises to create a faulty theory of credit.

For another recent interpretation of the monetary and credit theories of Mises see the Internet publication *Mises on Money* by Gary North[2], who presents the opposite view. My readers can compare the two and are in an excellent position to make up their own mind.

The great evil of our age, unlimited credit expansion, cannot be understood, still less corrected, on the basis of a faulty theory of credit. This is the reason why I have taken the trouble, and liberty, to develop a new theory which will restore Adam Smith's Real Bill Doctrine to its proper place, and will draw attention to the fact that *it is possible to replace the banking system in a modern economy with real bill circulation*, provided that the Mint is opened to gold first.

Note: The characters of the cotton dealer, the spinner, and the weaver in my Second Greatest Story Ever Told were borrowed from Mises (*op. cit.* p. 345).

[2]*Gary North, Mises on Money, Part 4: Fractional Reserve Banking, January, 2002, https://archive.lewrockwell.com/north/north86.html*

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Just Leave Them Enough Rope to Hang Themselves

My efforts here at Gold-Eagle University to work out a blueprint for the return to a gold standard and thereby to escape credit collapse were rewarded by J.N. Tlaga. He came out with a critique of my plan (*At First for Buses Only*, www.gold-eagle.com/editorials_02/tlaga072902.html). Mr. Tlaga had also put forward a blueprint of his own (*The Alternative Future*, www.gold-eagle.com/editorials_01/tlaga112801.html).

My own credentials to devise a blueprint for monetary reform include a 5-year tour of duty on Capitol Hill. In 1985 Former Congressman W. E. Dannemeyer of California invited me to work in his Congressional office as his advisor on fiscal and monetary reform. Mr. Dannemeyer was to lead a delegation of ten Republican Congressmen to the White House. The only item on the agenda was monetary and fiscal reform. I was entrusted with the task of preparing a draft proposal for the perusal of President George Bush. We have considered the inclusion of an outright return to a gold standard. The stumbling block was the 'fixing' of the gold price. Whatever consensus might exist in favor of a gold standard, it would be wrecked as soon as a specific number was proposed as the official price of gold. Debtors and creditors would never agree on the same number. My proposal was that, as a preliminary, we should recommend a more modest plan. We should call for the refinancing of government debt in terms of gold bonds - a medicine American money doctors on an errand of mercy to Moscow had prescribed for the moribund Soviet economy only a few months earlier, at the eleventh hour. In other words, I proposed that the rate of interest should be stabilized first, and the dollar afterwards. In October, 1989, the delegation under the leadership of Mr. Dannemeyer met President Bush in the Oval Office and presented the Gold Bond Plan. The President listened intently, and instructed his Secretary of the Treasury, also present at the meeting, to schedule a conference of his staff and that of Mr. Dannemeyer to prepare the final draft on the proposal. The conference was scheduled and rescheduled three times by Treasury officials, before I realized that I was wasting my time in Washington and left. So much for the power of Presidents to make a first very tentative step to a gold standard, in the face of

what Mr. Tlaga colorfully describes as the opposition of "armed gangsters".

In all the previous historic experiments with irredeemable currency there was *competition*: there were other countries still on a metallic monetary standard. In every instance, the experiment was a miserable failure, and irredeemable currency suffered an ignominious defeat, in full view of the whole world. The present experiment is the first in history in which the promoters of irredeemable currency take no chances and exclude competition altogether. Even the tiniest of countries is forbidden to adhere to a gold standard, by the revised statutes of the IMF. By opening the U.S. Mint to gold, and by revoking the legal tender protection of the irredeemable dollar (which the U.S. House of Representatives could order by a simple majority vote, on the strength of its Constitutional prerogatives) irredeemable currency could have competition once more. This would not be an "At First Buses Only" experiment. It would be a challenge of gold money to the hegemony of paper money. If the challenge was turned down, it would in itself be a victory. The opponent would be seen not to have accepted it for fear of defeat. For fear that the irredeemable dollar would lose against gold, as has every one of its predecessors: the continental, the assignat, the mandat, the Reichsmark, to mention but a few, did before it.

In Mr. Tlaga's blueprint "The Alternative Future", the monetary reform would have to live the odium down of robbing innocent people of their life savings through repudiation of paper currency, bank deposits, and debt. Why burden the new monetary regime with that odium, when the managers of the irredeemable dollar are so eager to shoulder it? Just leave them enough rope. There can be no doubt that, given free competition between the Gold Eagle coin and the irredeemable paper dollar (*minus* its legal tender protection), the depreciation of the latter will greatly accelerate, and the agony of "waiting for Godot" will soon be over. After all, *gold is gold*, and *paper is paper*.

Chapter 8

The Bills of the Goldsmith

(Lecture Eight)

The Second Greatest Story Ever Told, Chapter 9 - Marketability of Goods M
The Marketability of Paper - The Goldsmith as Banker -

Evolution of Marketability

I dedicate this Lecture to the memory of Carl Menger (1840-1921), monetary scientist; the founder of the Austrian School of Economics; author of the greatest book ever on economics (*Gundsätze der Volkswirtschaftlehre*, 1871, translated into English under the title *Principles of Economics*); one of the discoverers of the concept of marginal utility. He also introduced the concept of marketability upon which the theory of money and credit rests.

> *"The differences in the degree of marketability is of the highest significance for the theory of money. The failure to recognize this is one of the essential causes of the backward state of monetary theory. The theory of money necessarily presupposes a theory of marketability of goods."*
> *– Carl Menger*[1]*, On the Origin of Money.*

In the next Chapter of *The Second Greatest Story Ever Told* we shall see that the bank non-existent gold, but, quite legitimately, as a bill of exchange drawn on and

[1]*Carl Menger, On the Origin of Money, The Economic Journal, June 1892. Reprinted by CMRE, 10004 Greenwood Ct., Charlotte, NC 28215.*

accepted by the goldsmith. Just as the market promoted gold to the station of money through the evolution in its marketability, so the goldsmith's bill was promoted and became the bank note, through a similar evolution in its marketability among bills of exchange.

Chapter Nine

(in which the gentle reader learns why the traders picked the bills of the goldsmith)

Traders at the Discount House noticed that the bills drawn on and accepted by the goldsmith behaved quite differently from other bills. Although they were, just as any other bill, maturing within 91 days, they were coming back to the goldsmith after a few weeks or even a few days of circulation. Not as if anything about them was suspect. On the contrary: the bills were 'too good'. They circulated too fast. Further circulation was hampered by the limitation of space on the back used for endorsements. When the bill's back was filled up with signatures, it had to be returned to the goldsmith who substituted another one with a 'clean back'. As this was a nuisance, soon the goldsmith solved the problem with a clever innovation. He instructed his suppliers that they bill him with the legend "payable to bearer" on the face of the bill. This innovation eliminated the necessity of endorsing, and the goldsmith's bearer bills were taken in and paid out almost with the same ease as were gold coins.

Then the goldsmith made a second interesting discovery. Now his bearer bills kept coming home 'late', sometimes weeks or even months after maturity. This was completely unknown in the experience of other merchants some of whom tried, unsuccessfully, to imitate the goldsmith in issuing bearer bills. Traders at the Discount House explained the mystery. As most people were holding the goldsmith's paper only for a fraction of a day, they did not bother calculating and charging the negligible discount due to them. The goldsmith's paper mostly changed hands at face value. In effect, the market segregated the bills according as the acceptor was the goldsmith or someone else. The goldsmith's bearer bills were no longer treated as an earning asset but, rather, as a surrogate of the gold coin, which was easier and safer to carry and to transfer. These bills circulated very fast indeed, even faster than the gold coin itself. Other bills were circulating much more slowly, as they were sought after mainly as an earning asset by merchants in their slow season who wanted to participate in the earnings of their colleagues in their high season.

The promotion of the goldsmith's paper was a spontaneous development. It had no roots in legislation, government patent or monopoly (nor in the lobbying activity of the Goldsmiths' Guild). The reason was also clear. A bill is considered more marketable if the drawer stands closer to the head of the line waiting for the consumer's gold coin. Thus the bill drawn on the clothier was more marketable than the one drawn on the weaver, which in turn was more marketable than the bill drawn on the spinner. Now the bill drawn on the goldsmith was more marketable than any one of those for the simple reason that the goldsmith was working with the very material of which the standard of value was made.

Soon enough people were making new demands on the goldsmith that were quite unrelated to his trade. Those who had to make several smaller payments but had only one large bill in their possession came to the goldsmith asking him to 'break' their large bill. Thereafter the goldsmith issued his bearer bills in standard denominations of $100, $500, $1,000. He then balanced the liability arising out of this issue not by gold coins but, at least in part, by large bills drawn on other merchants that have been presented to him for 'breaking'.

In an unrelated development, the goldsmith dropped the maturity date on his standard-denomination bills, as it served no useful purpose any more. The maturity date was replaced by the legend "payable to bearer on demand". These were called the goldsmith's "bearer sight bills", the precursors of the bank note.

The market process promoting the bill of the goldsmith to become the most marketable paper in the bill market was analogous to the market process that had earlier promoted gold to become the most marketable good in the commodity market. The latter was studied by Carl Menger in his seminal paper *On the Origin of Money* in *The Economic Journal*, in describing the concept of marketability.

There is a phenomenon which has from old and in a peculiar degree attracted the attention of social philosophers and practical economists, namely, the fact that certain commodities became universally acceptable as media of exchange. It is obvious even to the most ordinary intelligence that a commodity should be given up by its owner in exchange for another more useful to him. But that every economizing individual should be ready to accept a certain commodity … *even if he does not need it, or if his need for it is already satisfied*, in exchange for all the goods he has brought to the market, while it is none the less what he needs that

he first consults when acquiring goods … has been considered outright mysterious - even by such a distinguished thinker as Savigny …

The difficulties of barter would have proved insurmountable obstacles to the progress of trade, had there not lain a remedy in the very nature of things, to wit, *the various degrees of marketability* (*Absatzfähigkeit*) *of commodities*. The differences in this degree are of the highest significance for the theory of money. The failure to recognize this is one of the essential causes of the backward state of monetary theory. *The theory of money necessarily presupposes a theory of marketability of goods*.

The person who wishes to acquire certain definite goods in exchange for his own is in a more favorable position if he first exchanges his own wares for highly marketable goods. Then, through a second exchange, he can more easily acquire the goods he wants … Men have been led, with increasing knowledge of their own individual interest, without convention, without legal compulsion, nay, even without any regard to the common interest, to accept highly marketable goods in exchange for their wares … The most highly marketable goods have thus become, over a considerable period of time, the generally acceptable media of exchange … (*Op. cit.*, pp. 239-255).

The most marketable good that, through the evolution described by Menger, has ultimately become the generally acceptable medium of exchange, is gold. In the bill market an analogous evolution has promoted the goldsmith's paper to become the bank note, the most widely acceptable form of a bill of exchange. Even though all properly constructed bills showed a high degree of marketability, there was a difference. Some bills lacking a high recognition value might be less negotiable, their discounting might run into problems, and they might have difficulty in circulating.

What Is Involved in Selling House?

Take the case of selling a house. As we shall see, the exchange involved in this sale is quite a bit more complicated than it may appear at first sight. It involves no fewer than five different exchanges, until the deal is complete. I wonder how the finer details in such a common deal as the sale of a house could have escaped the scrutiny of economic theoreticians.

The buyer and the seller of the house agree on a closing date by which the seller can vacate it and the buyer can come up with the full purchase price. Suppose the closing date is two months away. The buyer expects that in two months he can liquidate some of his investments, say stocks, which will enable him to cover the price of the house. He knows that a nearby closing date may not let him get the best price for his investment, due to the limited marketability of stocks. On his broker's advice he needs about one month to get the best price. After one month the buyer of the house sold the stocks and received bank notes in exchange. As he realized that holding such a large amount in the form of bank notes for one month would involve him with a loss of income, he decided to get a bill to mature in a month or more to derive an income on his funds for the interim period. On the day of closing the deal, the buyer of the house discounted his bill. Since this was a highly marketable paper, he knew he would be able to do it on any day of his choosing. He discounted his bill against payment in the form of bank notes. There was no question about the acceptability of this instrument by the seller of the house, since the bank note was the most marketable paper there was. Later in the day the buyer of the house, in his turn, exchanged the bank note for another bill of exchange maturing in three months. He wanted to earn an income while he was finding a suitable investment for his funds. Ultimately, he wanted to invest the proceeds from the sale of the house in bonds. They earned a higher income than bills, but they were not as marketable. It would take time get them at the best price. The bond dealer suggested to him that a new issue would be floated in three months. After three months he used the proceeds of the 3-month bill to pay for the bond.

We can see that the sale of the house took six months and five exchanges to complete. All five exchanges involved the bank note, the common purchasing medium. The five exchanges were: (1) selling the stocks, (2) buying the 1-month bill with the proceeds from the sale of the stocks, (3) paying for the house with the proceeds from the sale of the 1-month bill, (4) buying the 3-month bill with the proceeds from the sale of the house, (5) paying for the bond with the proceeds from the sale of the 3-month bill. At that point the market agitation caused by the sale of the house came to rest.

We can see that the goldsmith's bearer sight bill, *alias* bank note, plays an important role in facilitating the purchase or sale of real estate, stocks, bonds, bills, etc. The goldsmith through his money-changing business has become a banker. His bank notes were considered mature bills (sight bills) which could be exchanged

for gold coins on demand at any time. There is no fraud involved. The bank note is *not* a warehouse receipt for gold on deposit. It is a bill of exchange that the market has promoted to the station of medium of exchange, for being more marketable than any other. People were happy to hold it, especially if they needed ready cash on hand for unexpected purchases, and they willingly paid for its use in the form of foregone discount. They were paying for the convenience to use a paper surrogate of the gold coin, in applications where the direct use of the gold coin would be less convenient.

Where Paper Cannot Deputize for Gold

The bank note could be used as cash universally. The question arises whether it could serve as a surrogate of the gold coin in every application. Mises gives an unconditional "yes" as the answer. My answer is that there are several applications where it could not, two of which I have already mentioned earlier. The consumer must have gold coins, rather than bank notes, to pay for consumer goods the production and distribution of which has been financed with bills of exchange (or, what is the same to say, to buy goods belonging to the Social Circulating Capital). The gold coin is the consumer's 'ballot paper' with which he casts his vote on a daily basis, conveying a message of his satisfaction or dissatisfaction with their services to the producers and distributors of consumer goods (See Lecture 2). He must have the gold coin, otherwise he would be deprived of his right to vote.

Another example where paper cannot deputize for gold is the payment of a bill of exchange at maturity (see Lecture 6, Chapter Five), for the same reason that a bill cannot be settled at maturity by redrawing it, and 91 days is the absolute limit for its maturity. In order to safeguard the integrity and solvency of the clearing system, gold coins must be used for this purpose. The gold coin in the possession of its ultimate guardian, the sovereign consumer, will retire the real bill at maturity.

A third and most important exception will be discussed in my next course in this series entitled *Gold and Interest*, to start in the Fall Semester. In it I shall introduce a character called the "marginal bondholder". He is the first to sell his bond when the rate of interest drops. He finds the low rate unrealistic and unacceptable. He is willing to take profits on his holdings of bonds, keep the proceeds in gold, and buy his bonds back at a lower price when interest rates rise again to a reasonable level.

If he were to accept the bank note instead of the gold coin in exchange for his bond, then he would be jumping from the firing pan into the fire. He must insist on payment in gold if he wants to assert his time preference, in protest against unreasonably low interest rates. Incidentally, as we shall see, this is a point that escaped David Ricardo as well as Ludwig von Mises. Mises specifically says that "claims [to gold coin] are *complete substitute* [for the gold coin] and, as such, are able to fulfill *all* the functions of [gold coins] in those markets where their essential characteristics of maturity and security are recognized" (*op. cit.*, p. 300, emphasis added).

Circulation of Bank Notes

The bank note, as I have mentioned already, is the most marketable among the bills of exchange. It is assumed that the banker (originally the goldsmith) holds a blend of gold and maturing real bills against this liability. As a bill matures in his portfolio, he has to follow one of three possible courses of action. Either he replaces it with its face value in gold coins; or he can discount an equivalent amount of fresh bills. As a third possibility, he may also retire an equivalent amount of bank notes from circulation. If he fails to do one of these things, then the bank note becomes a phony bill, and the banker a counterfeiter, just as the goldsmith in the fable who would issue fraudulent warehouse receipts against non-existent gold.

There is no mystery about the circulation of the bank note which, unlike a bill of exchange, is not an earning asset. It circulates because it satisfies a need very different from that of the bill of exchange. Unlike bills that cannot circulate after reaching maturity, that is, after they cease to be an earning asset, bank notes circulates indefinitely. I have expressed this by saying that the bank note is a sight bill. It is more versatile and convenient than other bills. It relieves the holder of the chore of keeping track of the various maturity dates. It is accepted as hand-to-hand money without the need to check the credit standing of the drawer and acceptor at every time a payment is received. (It goes without saying that the banker must have an impeccable name.)

Combining the business of the goldsmith with that of the money-changer was no fraud. As long as the bank note in circulation is properly backed by gold or by maturing real bills, there is no counterfeiting involved. The superficial similarity between the goldsmith's bearer sight bill (the bank note) and the warehouse receipt

representing gold deposited for safe keeping (the gold certificate) is misleading. Both instruments are promises to pay bearer so much gold on demand. But the difference, although less apparent, is far more significant. The bank note is not specific about the asset held against its issue, that could be gold, or real bills, or a blend of the two. The gold certificate, on the other hand, explicitly states that a specified number of gold coins are held on deposit to balance the liability. The legal and economic differences between these two instruments were well-understood by the goldsmith's creditors. They trusted the goldsmith that he would balance his liability represented by the bank note with a blend of gold coins and maturing real bills drawn against consumer goods in urgent demand. On the average, one-ninetieth of the real bills in his portfolio would mature every single day, bringing in more than enough gold coins to satisfy normal demand for converting bank notes. Holders of the goldsmith's paper also knew that the marketability of the assets in the goldsmith's portfolio guaranteed that even abnormal demand for gold coins could be met. The goldsmith could discount his bills with people in need of earning assets, or at the Discount House. Thus real bills could be liquidated at any time, virtually without loss. Bank notes were safe, and their issue did not give rise to credit expansion, as charged by Mises. For each bank note of face value $1,000 issued, the goldsmith had to withdraw $1,000 worth of real bills from circulation. For each $1,000 loan issued to a merchant in the form of a bank note, the banker would put the bill of exchange drawn on the merchant into his portfolio C a bill which, with a little more trouble, the merchant himself could put into circulation.

Run on the Bank - Wages of Dishonesty

There are those critics who assert that the removal of the maturity date from the goldsmith's bearer bill was a high-handed act. In any case, these critics say, it is impossible to make good on the goldsmith's promise if all the bearers of bank note show up at the cashier's window at the same time demanding gold. Critics conclude that the goldsmith's promise to pay bearer gold on demand is dishonest. It cannot be made good. As a proof, they cite the periodic runs on banks, the suspensions of convertibility, and the 'bank holidays'. They assert that the so-called 'fractional reserve banking' is unworkable and dishonest.

This is not a frivolous criticism, and it deserves a careful answer. The problem is in the double standard the government has in contract law. It gives special protection to banks, but not to other firms involved in bankruptcy. The government does this in return for the banks' cooperation in sheltering illiquid government paper in their portfolio. Unlike the bill of exchange, the government's treasury bill would not circulate. As part of a sweetheart deal, the banks would discount them along with the commercial bills of exchange. Incidentally, the real cause of bank runs is: illiquid assets such as treasury bills in the bank portfolio.

In the sequel we assume that the banks decline the government's request to discount treasury bills. In that case the phrase "fractional reserve" is a misnomer. The issue of bank notes is fully backed by reserves consisting of gold coins and bills of exchange maturing into gold coins. Nevertheless, it is true that if all holders of bank notes wanted gold from the bank simultaneously, there would not be enough to satisfy demand simultaneously. But what is the probability of this happening? In order to find the answer to this question we have to make certain assumptions about the intention of customers withdrawing gold. It is reasonable to assume that the majority wants gold because they would like to purchase earning assets. This part of the demand for gold presents no problem, as in retiring the bank notes the bank can sell an equivalent amount of earning assets. Other holders of bank notes may need the gold to make remittances abroad. This part of the demand presents no problem either. As the banks liquidates an equivalent amount of real bills from its portfolio, it is pushing up the discount rate at home relative to those prevailing abroad. Foreigners will find this country an attractive place where to buy real bills and, as a result, the gold will stay in domestic circulation. This leaves us to deal with the third and last group of holders of bank notes: those who are withdrawing the gold coin in protest against low interest rates. As long as this third group is a small minority, the bank can survive the run. It will sell a sufficient amount of assets in order to pay the holders of its bank notes in gold coins. Losses, if any, can be covered by canceling the shareholders' dividend for the quarter.

Thus the problem boils down to the case where a majority of people holding bank notes want to register a protest against low interest rates by demanding gold. If this protest is in response to the bank's hiding illiquid assets in the balance sheet, then, indeed, dishonesty is involved, and the run on the bank is just the wages of dishonesty. The protest is legitimate, and the resulting 'shortage' of gold is just a reminder who the boss is and what he thinks of the credit policy of the bank. The run is not an instance of a malfunction of the gold standard, nor is it a proof that

commercial banks cannot operate on the basis of real bills as liquid earning assets backing the note issue. Quite to the contrary: it shows that the gold standard is functioning exactly as it is supposed to. The public has the gold stick, and is using it to force the bank to play by the rules. We are justified in suggesting that virtually all the runs in the history of commercial banking have been of this type.

Stocks or Flows?

We shall now assume that the bank plays by the rules and it is not under pressure to monetize government debt, and that bank notes and deposits are balanced exclusively by gold and self-liquidating real bills. Can a run on the bank develop under those circumstances? History provides no guide in this regard: commercial banks have always been under pressure to monetize government debt. All we can say is that the possibility of a run on the bank is extremely remote. While remote, it cannot be ruled out. In order to put the problem in the right perspective we must look at analogous situations wherein the potential demand to use a facility, should it present itself simultaneously, cannot be met. There are many such cases. It is true that the George Washington bridge joining New York City to New Jersey could not meet the potential demand if all the people living in the vicinity wanted to cross it simultaneously. Was it therefore a mistake to build the bridge in the first place? Of course not! Is the Port Authority acting dishonestly when it posts toll charges and promises the right to pass on demand, 24 hours a day and 365 days a year, against the payment of the toll? Of course not! All bridges, roads, railways, ferries, elevators, etc., are designed and constructed with the understanding that not all potential users will want to use it simultaneously.

Murray Rothbard[2] advocates 100 percent gold reserves banking 'to eliminate dishonesty' in the promise to pay gold to the bearer of bank note on demand. Apart from the fact that there is no dishonesty in the promise as long as the bank is run properly, as explained above, even the 100 percent gold reserve would not remove the contingency that requests for redemption cannot be honored. There is always a remote possibility that an act of God, or human error, might temporarily prevent the bank from making good on its promise. In the realm of human existence no

[2]*Murray Rothbard, The Case for a 100 Percent Gold Dollar, Mises Institute, Auburn, Alabama 36832-4528.*

promise is ever free from such contingencies even if it is not explicitly stated C nor does honesty have anything to do with it.

The notion that the bank's promise, if it is to be honest, forces it to have a store of gold on hand equal to the sum total of its note and deposit liabilities stems from a fundamental confusion between *stocks* and *flows*. The promise of a bank, as that of every other business, refers to flows, not stocks. The promise is honest as long as they see to it that everything will be done to keep the flows moving. In the case of the bank, the promise is honest as long as the bank carries only self-liquidating bills, other than gold, in the asset portfolio backing its note and deposit liabilities.

"You Can't Imagine How It Pleased the People!"

If the goldsmith's creditors had ever had any doubts about the security and integrity of his money-changing business, then they would have accepted his bills only at a discount, or not at all. The financial annals fail to reveal an instance of a lawsuit filed against the goldsmith for fraud in misrepresenting sight bills as gold certificates or warehouse receipts. Such a charge, if one had been made, would have been thrown out of court with a remark from the judge to the effect that "plaintiff ought to familiarize himself with the difference between a promise and a certificate".

So did the Commercial Bank grow out of the goldsmith's money-changing business, and such was the evolution of the bank note from the bill of exchange. It is not possible to understand the circulation of the bank note without understanding that of the bill, and the evolution in the marketability of the bill of the goldsmith. The special status granted to the goldsmith's bill was free from government intervention and coercion (at least before the advent of central banking).

The goldsmith's money changing business was legitimate and honest. He offered his own bills, which were more convenient, more marketable, and more negotiable, in exchange for bills drawn on other merchants "which were less convenient, less marketable, and less negotiable." This was a genuine service for which people were willing to pay a fee in the form of foregone discount.

The truth is that the goldsmith's money changing business was the great success story of the Renaissance. It was not the beginning of the Great Fraud perpetrated on the people, aptly described in the famous paper-money scene:

Damit die Wohltat allen gleich gedeihe,
So stempelten wir gleich die ganze Reihe:
Zehn, Dreißig, Funfzig, Hundert sind parar.
Ihr denkt euch nicht, wie wohls dem Volke tat.
– Goethe's Faust, Part two, Act one.

(For an English translation, see Lecture 4). The Great Fraud, the disenfranchisement of the laboring classes, and the commissioning of the Invisible Vacuum Cleaner, was to come later. It was done in three stages: (1) making bank notes legal tender, (2) introducing bank notes of small denomination, as Mephistopheles astutely noted in the Faust story, (3) inventing the Acceptance House. The next Lecture will deal with the first two; the third will be the subject of Lecture 11.

The Holder of a Bank Note is a Creditor to the Bank

When someone accepts a bank note he becomes a creditor of the bank issuing it. This is clear if we consider that the bank note is basically a bill of exchange and the holder of a bill is a creditor. Making it a bearer sight bill does in no way change the creditor-debtor nexus. Mises demurs: "A person who accepts and holds [bank] notes grants no credit; he exchanges no present good for future good . . . The [bank] note is a present good just as much as the money" (*op. cit.*, pp. 304-305). The fact that the bank lists the bank note outstanding among its liabilities in the balance sheet does not make Mises to relent. He proves his contention by going, not to the balance sheet, but to the profit and loss statement which shows that the profit from the outstanding bank note accrues to the bank, not to the holder of the bank note. I cannot accept this argument. The profit arises from the discount that the holder of the bank note could collect, were it not for his conscious decision to forego it. He finds it more convenient to hold the bank note instead of the bill of exchange. He deliberately confers that profit, which could be his, to the bank, in exchange for a service that he considers more valuable.

Mises continues: "Is it then correct to say that when the bank discounts bills it does nothing but substitutes a convenient note currency for an inconvenient bill currency? Is the bank note really nothing but a handier sort of bill of exchange? By no means" (*op. cit.*, p. 307). In the rest of the argument Mises goes into the question whether the bank, in extending a loan in the form of bank notes, contributes to

the *demand* for or to the *supply* of credit. If it is the former, then the bank's action tends to raise the rate of interest; otherwise it tends to lower it. Here we got to the bottom of the disagreement. *Mises does not recognize the difference between the rate of interest and the discount rate.* My position is that as long as the bank holds only gold and self-liquidating bills to cover the bank note issue, it changes neither the supply of nor the demand for credit. There is no change either in the discount rate or in the interest rate. The case where the bank holds less marketable assets to cover the bank note issue will be discussed in Lecture 11 on the Acceptance House.

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Mises by North

Dear Gary:

I am struggling with your statement that "money is not a measure of value" (Gary North, *Mises on Money*[3]) supported by various quotations from Mises.

We are in complete agreement that the value of goods had its origin in the comparison of utilities to the individual, and under barter there was just no way to measure it, although values could still be compared, subject to the rules of ordinal arithmetic. But then, through the evolution in the marketability of goods, gold has been catapulted into the position of the most marketable good, money. Prices emerged for the first time, which could be compared as well as *measured*. They are subject to the rules of *ordinal* as well as *cardinal* arithmetic.

Mises[4] admits that the emergence of money, prices, and "the opportunity for exchange induces the individual to rearrange his scale of values" (*op. cit.*, p. 61). This, I take it, means that he rearranges it to conform to the constellation of prices. Since another individual will rearrange his own scale of values to conform to the same constellation, the valuation of individuals becomes universal. Prices harmonize individual values. Mises says that "if we wish to attribute to money the function to measure prices, then there is no reason why we should not do so" (*op. cit.*, p. 62). Thus the standard gold coin is rightly called the *unit of value*, and the price is rightly called the *measure of value*.

I am a professional mathematician and through my long career I have been trying hard to convince my layman friends that mathematics is much more than a science of counting and measuring. In particular, it is also a science of comparing. A large branch of mathematics called *lattice theory*, which also embraces ordinal arithmetic, is devoted exclusively to the study of comparing (ordering). In a typical lattice one cannot measure for lack of a metric. But then, there are also metric lattices in which both order and metric obtain, and the metric is compatible with the order. In these lattices comparing and measuring are both possible.

The mathematician is quite comfortable with the idea that in the beginning there was no metric in his lattice. Later, to his delight, he found a way to construct

[3]*Gary North, Mises on Money, Part I: Money, a market-generated phenomenon, January, 2002, (https://www.lewrockwell.com/2002/01/gary-north/mises-on-money/)*
[4]*Ludwig von Mises, The Theory of Money and Credit, Indianapolis (Liberty Classics) 1981.*

one, moreover, the metric was compatible with the order. To express this formally, let A, B denote goods and let a, b denote their respective prices. Furthermore, let $A < B$ mean that A is valued less than B. Then compatibility can be stated as follows: $A < B$ if, and only if, $a < b$. If there was a pair of goods A, B such that $a < b$ but $A > B$ (meaning that A is valued more than B even though it is the cheaper of the two) then arbitrageurs would buy A and sell B, and keep doing it until the anomaly in prices disappeared. This refutes Mises' dictum that it is "unscientific [to] attribute to money the function of acting as a measure of price or even of value" (*op. cit.* p. 61). Money does more. Through the market, money harmonizes individual valuations to become a universal valuation, applicable to all individuals, as manifested by the constellation of prices.

I would be grateful if you could show me the weak point in this argument.

Yours, etc.
Antal.

Chapter 9

Legal Tender Small Bank Notes

(Lecture Nine)

Tolerance Standards - Special Privileges for Banks - Small Is Ugly - Theory of Reflux -

Sources of Government Conduct

Today the concept of legal tender refers to coercion. The government orders its subjects to accept irredeemable promises in payment for the real goods and real services they produce. If people refuse to comply with the order, then they put themselves outside of the law. But the term legal tender hasn't always meant coercion. It originated in a right, not an obligation, of the people. As recently as in 1933, in the United States 'legal tender' referred to the right of the people to take their worn gold coins still within the established tolerance standards and exchange them free of charge for full-bodied ones. The government, by law, was obliged to pick up the cost of wear and tear in the coinage. Unscrupulous employers were prevented from short-changing wage earners by putting underweight gold coins into the pay envelope. This refresher of the semantics of legal tender is a helpful reminder how the government uses the subtle process of twisting the meaning of words to introduce coercion where there was none before, to turn a right into an imposition and, ultimately, to help itself to the wealth of its subjects without due process of the law.

While irredeemable paper currency relies on the strong arm of the government for its circulation, full-bodied gold coins have circulated freely without any legal

tender provision or other government interference. There was no need for coercion. Everybody was happy to take the gold coin in payment of wages or against the sale of goods. The government facilitated trade through non-coercive measures. Legal tender referred to measures to make it possible for the gold coin to circulate by tale rather than by weight. Circulation by tale simplified commerce enormously. Instead of weighing coins you simply counted them. This was achieved by committing the government to absorb the cost of wear-and-tear of the coinage, just as it is committed to absorb the cost of keeping highways in good repair. Tolerance standards were introduced, that is, a threshold of weight was established above which worn gold coins would still be received at face value at the Mint for re-coinage. Only gold coins below the threshold were valued by weight and were received at their actual bullion value. Banks and traders followed suit in accepting worn coins within the tolerance standard at face value. They knew that the Mint and the Treasury would take these coins from them. Thus the term legal tender, in the old sense, simply meant that the government stood behind the value of the coin of the realm even if it was slightly worn.

Another legitimate use of the concept of legal tender was the regulation of the circulation of silver and other subsidiary coins under the gold standard. As the gold/silver bimetallic ratio was variable, two problems could arise. If the bimetallic ratio rose, there could be reluctance to accept silver coinage in large quantities. If the bimetallic ratio fell, there was another threat. Silver coinage could disappear from circulation through wholesale melting or exporting of coins. To counter these problems, subsidiary silver coins were not made full bodied any more by the Mint. This took care of melting and exporting. To ensure smooth circulation of subsidiary coins without discounting which was in the interest of everybody, the Treasury was obliged to take them at face value, up to a certain limit per transaction regulated by legislation. Again, the market followed suit: banks and traders accepted subsidiary coins up to the same limit. By and large, these legal tender provisions worked as intended. Domestic and international circulation of silver and gold coins grew with the growth of world trade.

Serfs of the Leviathan

Legal tender legislation made the impression on the minds of some people that the government had the power to create value out of nothing by stamping a

higher value on a lower-valued piece of metal. They saw the legislation, not as an obligation imposed on the government in accordance with the original intention but, rather, as an obligation imposed on the citizens. Out of this misrepresentation of the original legal tender legislation, which in no way intended to limit the freedom of the individual, grew the Leviathan. It disenfranchised the savers and laborers. If legal tender legislation can make worn gold coins and cheap silver coins circulate at a face value higher than that of metallic content, then it can also make paper circulate at arbitrary values.

Enemies of freedom argued thus: Making paper money legal tender could be used to subjugate a free people, reducing them to the status of serfs in the service of the Leviathan, without their realizing just what is happening to them.

Yet there was a problem. All the bank notes in circulation were issued in large denominations. They were used only by people knowledgeable about the market, the condition of the banks, and about the credit of the government. The goldsmith did not issue bank notes of small denominations. His clients would have no use for it and would not take them. If the Great Fraud was to succeed, then it was necessary for the government to pull off a *coup*. Small bank notes should be put into circulation, and the laboring classes had to be mesmerized into accepting them.

"Small Is Ugly"

The introduction of bank notes of small denomination was inextricably intertwined with the granting of special privileges by the government to the banks of issue (banks authorized to issue bank notes). Invariably, these special privileges were highly detrimental to the public interest, and should have never been granted. The patent (monopoly) was reward for the favor of banks to monetize government debt. In practice, this meant that the banks were allowed to have a *fiduciary issue* of bank notes against government paper in addition to (but indistinguishable from) bank notes issued against gold and self-liquidating bills of exchange. The paper backing the fiduciary issue included government bonds and notes that the Treasury was unable to sell to the general public. These bonds and notes were automatically reissued upon expiry. In effect, the bank was carrying a *perpetual* government debt. This it could do only because the bank was able to pass the burden on to the shoulders of the general public in the form of non-interest-bearing paper: small

bank notes. Thus fiduciary currency, far from being a present good as suggested by Mises, is the worst possible type of future good one can have! The burden was passed on to the public, and the banks pocketed *riskless profits* in the form of interest payments by the government. Please note that it would not work with the issue of large bank notes. Holders of large notes would hang on to them for as short a period of time as was absolutely necessary, and then would pass them on to others, or would return them to the bank. Small is beautiful from the bank's point of view, but it is certainly ugly from that of the public.

A case in point is the establishment of the Bank of England. King Charles II had borrowed gold from the goldsmiths of London who held it on deposit from some 10,000 depositors. In 1672 the king refused to repay the loan and, naturally, the crown was having great difficulties in borrowing money thereafter. The goldsmiths presented their claims against the king in 1691 and, out of the agreement hammered out, the Bank of England was born. William Paterson, a Scotsman, offered to advance 1 million pounds to the government against its bonds on the following conditions: (1) the bonds were to pay interest at $6\frac{1}{2}$ percent *per annum*, (2) there was also a management fee to be paid, (3) the government granted the bank monopoly to issue bank notes in the London area. The notes of the Bank of England became legal tender in 1694, and the intervening three centuries did not afford an opportunity for the government to retire the bond against which the original 1 million pound worth of bank notes were issued. It will probably be retired only when the pound will have lost the remainder of its value.

Mises also considers the problem of small bank notes. "For reasons which were connected with certain views on the nature of notes it was thought that the circulation of notes of small denomination ought to be opposed. The battle against the one pound note in England ended with the complete victory of the sovereign (the one pound gold coin)", (*op. cit.*, p. 321). "Old British banking doctrine banned small bank notes (in their opinion, notes smaller than five pounds) because it wanted to protect the poorer strata of the population, supposed to be less familiar with the condition of the banking business and therefore more liable to be cheated by the wicked bankers", (*op. cit.*, p. 494).

There is a disturbing misprint on p. 494 where Mises talks about his proposed new gold standard for the United States (apparently this is no translation but was written in English by Mises himself in 1952). "It does not require any special mention that the new-stock legal-tender notes to be issued by the Conversion Agency must be issued only in denominations of one dollar or fifty dollars and

upward." For this to make sense, I think, the words "one dollar or" should be deleted. That is to say, Mises in 1952 advocated a new gold standard for the United States which would have excluded small bank notes. Unfortunately, he did not exclude legal-tender status for the larger ones.

Special Privileges Granted to Banks

It should be clear at once that under the pact between the government and the banks of issue the smooth redemption of bank notes has been seriously undermined, if not made outright impossible. It was no longer true that one-ninetieth of the banks assets matured every single day of the year, bringing in plenty of gold coins to satisfy normal demand. Nor was it likely that the banks could meet abnormal demand through liquidating assets.

Whereas real bills were highly marketable and could be easily liquidated through discounting at any time on short notice, government bonds had low marketability and their liquidation could involve the bank with losses. In fact, these losses could be quite substantial, in some cases they would wipe out the bank's entire capital. The banks were no longer in the position to operate on the same basis as before. They could no longer make good on their promise to redeem their notes in gold coin on demand.

The banks could continue operation only under special dispensation from the government. The dispensation was designed to protect the banks against the ire of their creditors in case of insolvency. The banks were given special privileges in the form of a patent which made it virtually impossible for their creditors to have legal recourse in forcing liquidation in case the banks failed to perform on valid contracts and obligations. But for the patent, should the bank fail to live up to its promise to pay, creditors would satisfy themselves from the proceeds of the liquidation of the banks' assets.

In effect the new dispensation meant the establishment of a double standard, one for the banks, and another for everybody else, in adjudicating cases that involved contract law. The banks, under the protection of the patent, enjoyed special privileges. They could disguise their breech of faith with creditors under solemn-sounding euphemisms. They could declare a 'bank holiday' or a 'suspension of convertibility', they could 'stand still' or 'go off gold' - and the use of any number of linguistic innovations to cover up the fact of fraudulent bankruptcy. By contrast,

other firms had to face the music if they could not perform on their contracts: their creditors could force their liquidation.

Mesmerizing the Laboring Classes

Still, the conspiracy between the government and the banks of issue would have been transparent and easy to expose if it wasn't for the trick that was employed to throw dust into the eyes and confuse the minds of the people. The trick was to maintain the pretense that there was a great unsatisfied demand for bank notes of small denomination out there. It was the government's responsibility to mint gold coins for circulation, so it had to provide a substitute in case of a dearth of gold. The idea was to put over on the public the notion that the fiduciary issue was necessary in order to meet the demand for small bank notes.

The argument is disingenuous. The allegation that gold coins would be in short supply if they were dispersed in the hand of the saving and consuming public is spurious. As we have seen, the producers of consumer goods did not need gold to finance their operations. They could use real bills as a means of exchange. Every urgent and legitimate business transaction in the service of the consumer gives grounds for drawing bills. The greater the urgency, the easier it is to discount commercial paper drawn against the movement of merchandise destined to satisfy consumer demand. Long-term business investments, on the other hand, should be financed by appealing to the saving public for accommodation, and the going rate on long-term funds should be paid. As long as these guidelines were followed, there could be no dearth of gold coins.

There was no genuine demand for bank notes of small denomination. Had there been such a demand, the goldsmith would have put them into circulation. The idea of a dearth of gold is a red herring. The issuance of bank notes of small denomination was clearly a ploy to fool labor. Gold and silver coins were drained from the pockets of laborers and other people of small means. When wage earners lost their right to demand gold and silver in exchange for their services, and dust was thrown into people's eyes in the form of bank notes of small denomination, the stage was set for the Great Fraud.

Thou Shalt Not Press Down Upon the Brow of Labor This Crown of Thorns!

We may paraphrase Daniel Webster (already quoted in Lecture 3) as follows:

> *"Of all the contrivances for cheating the laboring classes of mankind, none has been more effective than that which deludes them with* small-denomination *paper money."*

It was not the bank note *per se*, but the bank note of small denomination, that were instrumental in cheating the wage-earner out of his fair wages. The distinction is significant. The wage earner is supposed to be paid in gold or silver coin. This is his Constitutional right. With gold and silver coins jingling in his pocket he was the unquestioned master of the market place. His wishes were sacrosanct to all vendors and producers. He was the proverbial boss who was 'always right'. Bereft of his gold and silver coins he was reduced to the station of a serf. Important decisions such as what to produce, when, and how much, are now made without consulting him. He is now inubuilt-in obsolescence, to the lowest quality entertainment including pornography.

As pointed out above, the excuse of a dearth of gold is lame. But even if we assume, for the sake of argument, that there had been a dearth of gold, for that the blame belongs to the government and the banks. A dearth of gold is always an indicator of one or both of the following:

1. the banks are pursuing unsound credit policies, such as constructing a debt-pyramid upon a slim or non-existent gold base, or conducting illicit interest arbitrage in borrowing short to lend long (this will be the subject of the last two Lectures in this course).

2. the government is trying hard to monetize its debt, that is, make the banks buy the bonds it could not sell to the public.

The dearth of gold is merely a reflection of public distrust in the unsound and dangerous policies of the banks and the government.

William Jennings Bryan, fiery orator, populist politician, and unsuccessful presidential candidate said at the National Democratic Convention in Chicago in 1896:

"Thou shalt not press down upon the brow of labor this crown of thorns. Thou shalt not crucify mankind upon this cross of gold." Bryan thought that gold was the enemy and silver the friend of the working people, and the gold standard was the rich man's ploy to enslave labor. Unfortunately, in looking for adversaries he missed the real enemy of the laboring classes: paper.

Thou Shalt Not Crucify Mankind Upon This Cross of Paper!

The Constitution of the United States provides for a metallic monetary standard for the country. *This still stands.* Those who run the monetary system of the country could not face a Constitutional debate to change that (although they forced Switzerland to change her Constitution). This is indicative of the bad faith that permeates our present monetary system. Its managers would sooner open themselves to charges that theirs is an unconstitutional monetary regime than muster the necessary courage to propose changing this provision of the Constitution. They obviously have something to hide.

The Constitutional provision for a metallic monetary standard was not a rich man's ploy. It was grounded in the Founding Fathers' genuine regard for the welfare and advancement of the laboring classes. The gold and silver coins are the protectors of the wage earner. The rich man can usually protect himself against monetary mischief even without them. But collective agreements and wage contracts are not worth the paper on which they are written, if gold and silver coins in circulation do not give them substance. History proved the wisdom of the Founding Fathers. In 1971, as the Republic was approaching its bicentennial, there was nobody to cry loud and clear: "Thou shalt not crucify mankind upon this cross of paper money!" The world was quietly submerged in a sea of worthless paper.

The debasement of the dollar that started in 1971 has reached unprecedented proportions in American history. As a side effect, the labor movement in the United States was greatly weakened, unions getting decertified as bargaining agents by the hundreds, in no small measure because labor leaders have failed to stand up for the monetary provisions of the Constitution. This was a betrayal not only of the Constitution, but also the traditions of the labor movement, as shown by

the leadership of Ely Moore, the first union official ever to have been elected to the Congress in 1834. The ploy of turning the Constitutional monetary regime into a paper-mill aimed at depriving wage-earners of their right to wages payable in silver and gold coins has succeeded beyond the wildest dreams of its authors. There was not one single labor leader, in 1971 or since, to protest and to initiate a public debate exposing the unconstitutionality of this high-handed and arrogant way of trampling on the people's most elementary rights.

Tormenting Widows and Orphans

In forcing the issue and circulation of small bank notes the government has singularly failed in its solemn task to protect property rights of ordinary citizens against the crime of fraudulent bankruptcy. Traders in the bill market do not need government protection. They make it their business to keep themselves informed about credit conditions, the credit-worthiness of merchants who draw and accept bills of exchange. It is the wage-earners and other people of small means, the savers and, above all, the widows and orphans, who are in need of protection. They cannot be expected to have a clear notion of the risks involved in accepting bank notes purportedly equivalent to the gold coin. They cannot be expected to understand the intricacies of monetary circulation. They cannot be expected to realize that the privileged banks may indeed cheat the public by loading their portfolios with illiquid assets of dubious value. They cannot be expected to know about illicit interest arbitrage, balance sheets, matching maturities, borrowing short to lend long, or about a hundred technical tricks of the banking business which may adversely affect their financial well-being in the absence of gold and silver coins in circulation. They can hardly be expected to understand the legal concept of fraudulent bankruptcy through which they stand to be victimized, not only by the banks, but also by the government, their alleged Lord Protector.

It is this failure of the government to protect the property rights of the economically weak and defenseless, against unsound banking practices that has subsequently adulterated the gold standard and created monetary and economic havoc. *The circulating gold coin and uninhibited access to it is all the protection widows and orphans, wage-earners and others may ever need to protect their property rights.* With gold coins at their disposal they were the unquestioned masters, the sovereign savers and consumers, holding veto-power over the distribution of loanable funds,

and the disposal of the social circulating capital, as well as other banking decisions. Bereft of the circulating gold coin, they no longer need to be consulted and, worse still, their protection against plunder is gone. With the removal of the gold clauses from government bonds, they have become the prime target to be victimized by deliberate currency debasement and devaluations. In abandoning them to their fate, the government has ignored the repeated admonition to the tormentors of widows and orphans in the Bible.

The government is bringing upon itself the Biblical curse that all those found guilty of this crime that "cries to heaven" are predestined to suffer.

Theory of Reflux

Not only did the government fail to protect legitimate property rights, but it became an accomplice in allowing insolvent banks to declare bankruptcy fraudulently. There is no need for government regulation of bank notes in circulation. Before they were given privileged status, the banks had not been in the position to 'overissue' their bank notes. The unwanted bank notes flowed back to the issuing bank, and would be exchanged for gold or for highly marketable earning assets such as bills of exchange. In the absence of special privileges, the public would regulate the quantity of bank notes in circulation.

This "theory of reflux" was criticized by Ludwig von Mises and other monetary scientist, who ridiculed the idea that the public can regulate the quantity of bank notes in circulation. They argued that even redeemable bank notes stay permanently in circulation and can cause mischief. However, these critics ignore the fact that the theory of reflux refers to bank notes of large denomination only. Their holders will have them only as long as necessary, and will exchange them for earning assets or for gold as soon as practicable. To assume that bank notes of large denomination can stay in circulation indefinitely contradicts the basic assumption of rational behavior of actors in the market place, led by an 'invisible hand' to protect their own interest.

Mises and other critics of the theory of reflux confuse this problem with an entirely separate one, namely, the problem of small bank notes which, indeed, stay in circulation indefinitely after they have been issued. People of small means, who have been coaxed out of their possession of silver and gold coins, will hold them as a form of saving. Later on, bank notes issued by private banks have been

adorned with government stamps and embellished with signatures of government officials to foster the public's (mistaken) belief that, even if there were crooks in the privately owned banks, the government was surely above the crime of fraudulent bankruptcy. Holding bank notes of small denomination as a form of saving was safe in the public's eye.

Critics also ignore the role of special privileges of banking institutions in discouraging the reflux. To the extent that they enjoy privileges the circulation of bank notes cannot be considered free. Bank notes of small denomination get into the hands of the great masses of people who know nothing of the need for protecting their savings through the redemption of idle bank notes. Using subtle (and sometimes not so subtle) methods the privileged banks can easily dissuade their small depositors and holders of small bank notes from exercising their right of redemption. If gentle dissuasion is not enough, the government is not far behind to help protect the interest of the privileged banks against that of the public by less gentle means. The legal obligation to redeem small bank notes (or any bank note) in gold could be abolished by a government edict while still maintaining the pretense of a gold standard under the euphemism of gold bullion standard (respectively, gold exchange standard), as it was done in several countries including Britain in 1925 (respectively, in the United States in 1934). The history of bank notes clearly shows that governments are led by considerations other than protecting the legitimate interest of their citizens and creditors against fraud, upholding property rights, and the sanctity of voluntary contracts.

Sources of Government Conduct Regarding Money and Banking

There is no valid reason why governments should exempt banks from the full weight of the provisions of contract law. There is no valid reason for granting special privileges to banks and other financial institutions. There is no valid reason for introducing and maintaining a double standard of conduct - one for the privileged banks and another for everyone else. There is no valid reason for granting privileges without imposing countervailing responsibilities.

The real sources of government conduct regarding money and banking are not hard to find. The government, notwithstanding its profession of high democratic

ideals and dedication to public service, is first and foremost interested in perpetuating and aggrandizing its own power - most often by allying itself with a powerful minority against the interest of the powerless and ignorant majority. This matter is certainly not allowed to enter the domain of party-politics. With the rarest exceptions, the governing party is in collusion with the opposition party over the issue of exploiting the ignorance of the powerless majority on all matters pertaining to money, credit, and banking. The party in opposition expects to assume power before long; it is not going to spoil the broth that is cooking not only for the benefit the present incumbent, but also for that of future incumbents as well. Bank regulation, special privileges and exemptions granted to banks are ideally suited to throw dust into the eyes of the public.

From Double Standard to Double Dealing

As suggested by John Maynard Keynes, only one man in a million may understand the subtlety of pauperizing people through the legalization of fraudulent bankruptcy, deliberate currency debasement, and in depriving people of small means of the protection of the gold coin. The past three hundred years, ever since the introduction of central banking in England, bear eloquent witness to this proposition. There is no length governments would not go on the slippery road of subverting voluntary contracts, breaking solemn promises, defrauding their own citizens and creditors when it comes to aggrandizing their own power. Moreover, all this is done in such a way as to maintain the pretense of legitimacy, even the high-mindedness of government action. The villain of the piece is always outside the government, the speculators, the arbitrageurs, the hoarders of gold and silver, the traders in foreign exchange, managers of productive enterprise - they are the ones who display unpatriotic behavior and greed. They are the ones who must be punished for their ‘anti-social’ behavior. The party in power would never admit, and the party in opposition would never charge that this witch-hunt is designed to find scapegoats and pull the wool before the eye of the public.

The government has been successful in confusing the issue. Not only did the public fail to see the self-serving and self-aggrandizing intention: the government’s image as the benevolent protector and the source of countless public benefits was preserved intact, if not enhanced. The truth, however, is that in the domain of contract law, money, banking, and credit, governments have always applied a

double standard. Their motto is: "Do as I say, not as I do!" Governments did not stop at introducing double standards. They went on to use them as the basis for double dealings.

Present Versus Future Goods

Credit involves exchanging present for future goods. It is therefore essential for us to clarify where the dividing line between the two lies. I wish to return to what in Lecture 7 I called a mistake of Mises not to recognize clearing as a source of credit (Mises on Fiduciary Credit). In the *Theory of Money and Credit* he states: "A person who accepts and holds a [bank] note grants no credit; he exchanges no present good for future good . . . The [redeemable bank note] is a present good just as much [as the gold coin]" (*op. cit.*, pp. 304-305). Elsewhere in the book Mises emphasizes the gratuitous nature of credit. The act of issuing a bank note (or creating a bank deposit) imposes no sacrifices on the part of the bank - apart from the insignificant cost of printing and book-keeping - so that, in this view, the bank has the power to create present goods virtually out of nothing.

This notion appears to be at odds with the author's well-known position that it is ludicrous to believe, as inflationists would have us believe, that the government can create wealth out of little scraps of paper by sprinkling some ink on them. But if the banks can do it, why can't the government?

You might argue that this latter view Mises expressed later, and it is not fair to set the contrast between two views of an author expressed half a century apart. Indeed, it wouldn't be fair if Mises had recanted his view he expressed in the 1912 first edition, that a bank note is a present good. But I found no trace of any intention to recant in later editions. I am at a loss to explain why Mises himself, or Mises scholars, have failed to focus on this apparent contradiction. I shall be grateful for any hints that can help dispel the mystery. It is possible that Mises, who was a careful thinker, dismissed the problem as a necessary semantic compromise. However, the problem is real and cannot be conjured away through semantic disputes. It goes right to the heart of the theory of money and credit. It will come back to haunt when we are ready to develop the theory of interest. If we blot out the difference between a present good and a promise to deliver a present good to bearer on demand - as Mises appears to be doing - then we give a powerful incentive to the banks and the government "to keep up the good work",

and continue to create through credit expansion present goods out of nothing to abolish scarcity for the benefit of society. As we know, this is what the banks and the government have been trying to do in the twentieth century, with disastrous results.

When a Liability Ceases to Be a Liability

Of course, Mises acknowledges the fact that the bank note issue is a liability of the bank and it must be so represented in the balance sheet (*op. cit.*, p. 305). I have dealt with this argument already in my Lecture 8 (The Holder of a Bank Note Is a Creditor to the Bank), and I wish to return to the problem once more. There are many other problems arising out of the assertion that a bank note as a present good. They gain new relevance now, in view of the accounting scandals on Wall Street. According to Mises the bank note is a 'present good' which, nevertheless, is a liability at the same time. Therefore the bank note is the only present good in our experience from which the 'producer' cannot walk away, it being also a liability. This does not seem to agree with our common-sense idea of a present good which, one may assume, should not be so encumbered. The producer of a present good ought to have unconditional right of disposal, including the right of walking away from it.

We may try to solve the problem by ruling that the bank note is a present good in the hand of the public, but not in the hand of the bank. But this line of argument raises awkward questions how it is possible that, of two bank notes with identical physical attributes, one is a present good and the other is not, and those attributes could not give you a clue to which of the two kinds it belongs. Actually, Mises maintains that the bank note is a present good in the hands of the issuing bank. It could be put into circulation even without loan transactions, e.g., by purchasing supplies or services with it.

But then it is legitimate to ask at what point in time the bank note has become a present good. Perhaps it was the moment the ink dried on the paper; or the moment when the bank took delivery of their shipment from the printing-shop. Either answer is unsatisfactory. In the latter case we would, once again, look at two identical bank notes one of which is a present good and the other is not. The former is even more awkward because it suggests that it is the printer, not the banker, who has the power to create present goods out of nothing.

Mises suggests that looking at the balance sheet does not reveal the true nature of the process of making a present good out of the bank note. A better approach is to go to the profit-loss account where we find a tell-tale entry: profit on loans. Since the profit accrues to the bank, and not to the holder of the bank note, Mises concludes that, in issuing the note the bank is granting credit rather than seeking it. And by the act of granting it, the bank has created a present good out of nothing, in the form of a bank note.

Upon closer scrutiny, we are still not closer to the solution of the problem. How do we know that the bank's profit is legitimate? Perhaps it is the result of extortion, and the bank is just pocketing it without having good legal, ethical, or economic title to it. In the last Chapter of The Second Greatest Story Ever Told I shall tell you about the Acceptance House that has conspired with the issuers of fictitious bills of exchange, and pocketed the difference between the rate of interest and the discount rate - a case of extortion. Could it be that the Acceptance House is the precursor of the illegitimate business of the banks of issue?

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Do Not Give in to Evil, but Proceed Ever More Boldly Against It

Bill O'Connor (SanBill@aol.com) tells me that I have the "wrong approach". He writes:
"Sir, your intellectual approach will never work. It is a little like reading the Ten Commandments to Big Al Capone while he is in the midst of a bank stickup. The only thing we have on our side is time - if we live long enough."
Bill.

Bill,
I am addressing the younger generation. I am not preaching to the culprits. I will have achieved my goal if the young people start thinking about these problems. You are right in saying that time is on our side. I hope that by telling it as it is time I can shorten it.

It is part of our Western cultural tradition not to give in to fate as if it was inevitable, but fight evil by all means at our disposal, and redouble our efforts when our situation looks most forlorn and hopeless. This is also the characteristic of being human: we do it even if we know we shall not live long enough to see and enjoy the result of our efforts. I guess this is the meaning of the lifetime motto Ludwig von Mises chose as a student from Virgil: "Do not give in to evil, but proceed ever more boldly against it."

Chapter 10

The Revolt of Quality

(Lecture Ten)

Deliberate Dollar Debasement - The Congenital Disease of All Paper Currencies - Omnipotent Government - Demonetizing Gold -

The Portuguese Bank Note Case

At the end of the previous Lecture I ran out of time and couldn't include the story of the Portuguese bank notes as I had intended. It is such an amusing and instructive story that I would not let you miss it, so I start with it this time.

Mises' dictum that the bank note is a present good naturally leads to the tantalizing question whether an undetected counterfeit bank note is a present good as well. Exactly the same argument that made the genuine bank note a present good would make a counterfeit bank note a present good, too. Pity, this puts the bankers and counterfeiters into the same class: they are both in the business to create present goods out of practically nothing. I would be happy to rest my case there, however, it raises more questions than it answers. Should the practice of producing present goods out of nothing be outlawed along with quackery and witchcraft regardless whether this dangerous prestidigitation is practiced by honorable gentlemen, the bankers, or by disreputable crooks, the counterfeiters? Both the banker and counterfeiter are illusionists, mesmerizing the public into believing that their product, the bank note, is a present good and not merely a promise to deliver present good on demand. Both the banker and the counterfeiter are determined to escape any and all responsibility concerning the bank note after

they have succeeded in putting it into circulation. The activities of the two are hardly different from an economic point of view. The difference is exclusively in our legal arrangements, aiding and abetting the former, while criminalizing the latter. It should criminalize both.

The following example, known as the Portuguese bank note case, is quite instructive and you will be pleased to hear it. In the late 1920's an astonishing and ingenious crime led to a fascinating civil suit that was not without its ironic side. A gang of international swindlers succeeded in convincing the well-respected London firm Waterlow & Sons, engravers of postage stamps and bank notes, that they were the representatives of the Bank of Portugal placing an order for the printing of a large quantity of fresh Portuguese bank notes. The order was duly filled and the bank notes were delivered to the swindlers. When the fraud was finally discovered, the Bank of Portugal was forced to call in all its extant notes, replacing them with a new issue. The criminals were never apprehended, but the Bank of Portugal sued Waterlow & Sons in British courts, demanding compensation for losses resulting from the issue of fraudulent notes. In listening to expert testimony the Court discovered that the case involved issues of unusual subtlety and complexity. The Court admitted evidence of negligence, but the question of damages was another matter. If it had been postage stamps instead of irredeemable bank notes in which the swindlers had trafficked, it would have been clear that the loss incurred by Portugal was equal to the face value of the fraudulent issue. With respect to bank notes, however, no such simple assertion could be made. Among the questions that troubled the experts the following stood out as particularly relevant to our study: would the Bank of Portugal have issued the same amount of bank notes even if the swindlers had not done so? If not, was the increase in the supply of paper currency resulting from the fraudulent notes beneficial or detrimental to the Portuguese economy? Some experts even testified that the swindlers may have done an unintentional favor to Portugal in helping fend off an imminent deflation. At any rate, why should the face value, rather than replacement value of a counterfeit bank note, govern considerations for damages, if the bank note is irredeemable anyway? These and other considerations led the high court to award only a small fraction of the damages claimed. See: C.H. Kisch[1], The Portuguese Bank Note Case.

[1]*C.H. Kisch, The Portuguese Bank Note Case, London, 1932, and Wilhelm Röpke, The Economics of Free Society, Chicago, 1963.*

The Yellowback Saga

My next example will, more than any other, demonstrate the difference between a present good and a promise to deliver a present good to bearer on demand. A U.S. $20 gold certificate (nicknamed the "yellowback" in order to distinguish it from the "greenback") and a U.S. $20 gold coin were both present goods, in the sense of Mises, on Saturday, March 4, 1933, the day of the inauguration of F. D. Roosevelt as the 31st president of the United States. The new president was elected to office in 1932 on a platform which contained the following preamble:

> *Believing that a party platform is a Covenant with the people to be faithfully kept by the party when entrusted with power, and that the people are entitled to know in plain words the terms of contract to which they are asked to subscribe, we hereby declare this to be the platform of the Democratic Party …*

and this declaration:

> *A sound currency is to be preserved at all hazards.*

During the election campaign of 1932 Mr. Roosevelt chastised president Hoover for endangering the integrity of the dollar by uttering irresponsible remarks about the possibility of going off the gold standard. There appears to be no evidence that Mr. Roosevelt favored the debasement of the dollar prior to his election. But debasement began very soon after inauguration. By the Emergency Banking Act, passed by Congress and signed into law on March 9, 1933, the president was empowered to prevent the hoarding and exportation of gold. Next day the Administration took the first step by refusing license to exporters of gold. With that refusal the dollar and the yellowbacks with it declined sharply in terms of gold and foreign exchange abroad. *For all intents and purposes the yellowback ceased to be a present good.* Lest there remain any doubt about the matter, on April 5, 1933, an Executive Order was issued requiring the owners of gold coins, gold bullion, and gold certificates (yellowbacks) to deliver these items to a Federal Reserve bank against replacement in the form of Federal Reserve notes (greenbacks) on or before May 1, 1933. The Executive Order specified heavy penalties for non-compliance.

Deliberate Dollar-Debasement

Actual debasement of the dollar was authorized under Section 43 of the Agricultural Adjustment Act of May 12, 1933, the "Thomas Amendment", empowering the president to reduce the gold content of the dollar. On June 5, 1933, Congress passed a "Joint Resolution to assure uniform value to the coins and currencies of the United States". This recited that holding and dealing in gold affected public interest and were therefore the object of regulation; that the provisions of obligations which purport to give the obligee the right to require payment in gold coin obstructed the power of Congress to regulate the value of money and are inconsistent with the policy to maintain equal value of every dollar coined or issued. It then declared that "every provision in any obligation purporting to give the obligee a right to require payment in gold is against public policy, and directed that every obligation, heretofore and hereafter incurred, whether or not any such provision is contained therein or made with respect thereto, shall be discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender for public and private debts".

The final status of the yellowbacks remained unclear until 1935, when the U.S. Supreme Court decided against the creditors of the U.S. government (Nortz v. the United States). In this landmark decision the high court ruled that the government of the U.S. did not act unconstitutionally in breaking its promise, stated on the face of the gold certificate:

> *This certifies that there have been deposited in the Treasury of the United States of America twenty dollars in gold coin of present weight and fineness, payable to bearer on demand.*

In the opinion of the Court:

These gold certificates were currency …Being currency and constituting legal tender, it is entirely inadmissible to regard the gold certificates as warehouse receipts. They were not contracts for a certain amount of gold as a commodity. They called for dollars, not bullion.

However, in the words of Justice McReynolds who formulated the minority opinion of the four dissenting justices,

These were contracts to return gold left on deposit; otherwise to pay its value in currency.

The majority of the Court argued that the Constitution granted monetary powers to the government, including the power "to coin money and regulate the value thereof". Therefore, the breaking of this promise fell within the power to regulate the value of coin. The Court side-stepped the issue whether another provision of the Constitution, denying the power to the government to deprive citizens of property without due process of the law, was violated or not. Incredibly, the high court even argued that no loss accrued to the citizens in consequence of the arbitrary action of the government, because the domestic purchasing power of the Federal Reserve notes remained identical to that of the yellowback which it replaced. In saying this, the high court ignored the immediate and sizeable losses of individuals under the jurisdiction of the United States who had obligations payable in foreign currency, as well as losses of citizens living in or visiting foreign countries.

Appalling Legal and Moral Chaos

Justices McReynolds, Van Devanter, Sutherland, and Butler disagreed with the majority of the court. The dissenting opinion was delivered by Justice McReynolds. It should be taught in American schools along with the *Emancipation Proclamation*.

> *We conclude that, if given effect, the enactments here challenged will bring about confiscation of property rights and repudiation of national obligations. Acquiescence in the decisions just announced is impossible; the circumstances demand a statement of our views. To let oneself slide down the easy slope offered by the course of events and to dull one's mind against the extent of danger . . . that is precisely to fail in one's obligations of responsibility.*
> *Just men regard repudiation and spoilation of citizens by their sovereign with abhorrence; but we are asked to affirm that the Constitution has granted power to accomplish both. No definite delegation of such power exists; and we cannot believe the far-seeing framers, who labored with hope of establishing justice and securing the blessings of liberty, intended that the expected government should have authority to annihilate its own obligations and*

destroy the very rights which they were endeavoring to protect. Not only is there no permission for such actions; they are inhibited. And no plentitude of words can conform them to our charter.

The federal government is one of delegated and limited powers which derive from the Constitution. It can exercise only the powers granted to it. Powers claimed must be denied unless granted … The fundamental problem now presented is whether recent statutes passed by Congress in respect of money and credits, were designed to attain a legitimate end. Or whether, under the guise of pursuing monetary policy, Congress really has inaugurated a plan primarily designed to destroy private obligations, repudiate national debts, and drive into the Treasury all the gold within the country, in exchange for inconvertible promises to pay of much less value. Considering all circumstances, we must conclude they show that the plan disclosed is of the latter description and its enforcement would deprive the parties before us of their rights under the Constitution. Consequently the Court should do what it can to afford relief …

The end or objective of the Joint Resolution [of June 5, 1933] was not 'legitimate'. The real purpose was not 'to assure uniform value to the coins and currencies of the United States', but to destroy certain valuable contractual rights …

These words of Alexander Hamilton ought not to be forgotten: "When a government enters into contract with an individual, it deposes, as to the matter of its Constitutional authority, and exchanges the character of legislator for that of a moral agent, with the same rights and obligations as an individual. Its promises may be justly considered as excepted out of its power to legislate, unless in aid of them. It is in theory impossible to reconcile the idea of a promise which obliges, with a power to make a law which can vary the effect of it …"

It was not intended to give Congress the power under the law to repudiate the obligations in question … No such power was ever granted by the framers of the Constitution. It was not there then. It was not there yesterday. It is not there today. We are confronted with a condition in which the dollar may be reduced to 50 cents today, to 30 cents tomorrow, to 10 cents the next day, and to 1 cent the day after …

Under the challenged statutes it is said that the United States has realized profits amounting to $2,800,000,000. But this assumes that gain may

> *be generated by legislative fiat. To such counterfeit profits there would be no limit; with each new debasement of the dollar they would expand. Two billions might be ballooned indefinitely to twenty, thirty, or what you will.*
>
> Losses of reputation for honorable dealing will bring us unending humiliation. The impending legal and moral chaos is appalling.

Congenital Disease of All Paper Currencies

Thus did the yellowback cease to be a 'present good' at the stroke of a pen in 1935. At any rate, the market had long recognized the true state of affairs: it treated the yellowback as a dishonored paper. By contrast, the $20 gold piece was still a present good after the Supreme Court decision as it is still today. So is the gold Napoleon. They continue to be a present good on the same terms indefinitely, whatever fate awaited the issuer. Paper money issued under the authority of Napoleon III, of course, no longer enjoys present-good status. They and the yellowback have suffered from the same congenital disease of all paper currencies: their status is tied up with the fortunes and integrity of the issuing authority. The gold coin is free from this congenital disease precisely because, unlike the paper currency, it is a present good, not a promise.

I treated the saga of the yellowback at length because it shows, I think, that Mises' concept of a present good is untenable. The yellowback lost its status as a present good, as the term is understood by Mises, for no cause more substantial than a stroke of the pen. This not only violates one's intuitive idea of a present good, but also obscures the real state of affairs. It appears to condone the mischief involved in the prestidigitation. There is no need to stretch the meaning of the term 'present good'. A perfectly satisfactory term to cover bank notes and other varieties of paper currency redeemable in gold already exists: they are promises to pay bearer a definite quantity of gold on demand. The value of a present good can be protected against physical deterioration by its owner in taking precautions to prevent it. The value of a promise cannot be so protected: it depends on the integrity of the other party and that of the prevailing legal system. A promise can be broken, no matter how carefully one protects the paper on which it is written. Nor does it matter who the promisor is and what what resources are at his disposal. As our example shows, even if the promise has been issued by the government

of the richest and 'most democratic' country on the face of the earth, with vast economic and military resources at its command, and even if the promise is backed up by Constitutional guarantees, a promise is still just a promise, and not a present good. Greater economic and military power won't make a country less likely to stoop so low as to have recourse to fraudulent bankruptcy, in order to destroy the contractual rights of weaker countries or individuals.

Gold needs no endorsement. It can be tested with scales and acids. The recipient of gold does not have to trust the government stamp on it if he doesn't trust the government that had stamped it. No act of faith is called for when gold is used in payments, and no compulsion is required. Gold is gold, and paper is paper. A present good is a present good, and a promise is a promise. Finally, whether the highest of high courts admits it or denies it, a broken promise is just that: a broken promise.

Omnipotent Government

Apparently, Mises maintains that even an irredeemable bank note is a present good. However, to call an irredeemable bank note a present good is to admit that the banks and the government can indeed create wealth out of little scraps of paper by sprinkling some ink on them. It is an admission that governments are omnipotent. But if we are to admit this, then we are forced to acknowledge that the regime of irredeemable currency, based on broken promises and on the prerogative of the government to declare bankruptcy fraudulently or, in most general terms, on contemptuous disregard for the rules of civilized dealings between individuals and the government, can endure indefinitely.

Apologists for the regime of irredeemable currency have no patience with this analysis of the historical origins of their regime. They refuse to face the fact that the viability of their regime is based on a deliberate confusion between present and future goods, that is, ultimately, on human gullibility. They try to assume a pragmatic stance. "Let bygones be bygones", they plead. "What alone matters is that the system works and will endure, because all that remains to clear up is this trifling matter of finding the 'optimal' rate at which the money supply is to be increased in order to stabilize the value of the monetary unit." I can dispose of the pragmatic argument that, indeed, there is a unique formula defining the optimal rate of increase in the quantity of irredeemable currency, in one sentence.

The declining value of irredeemable currency is not a result of having the 'wrong' rate of increase in its quantity, but it is a result of surreptitiously smuggling an item from the liability column to the asset column of the balance sheet of the government.

The proposition that the regime of irredeemable currency can endure indefinitely flies in the face of historical evidence. No irredeemable currency has ever survived the test of times. If it was not made redeemable in specie in good time, then it ignominiously lost all its value in due course. Nor was the destruction of value caused by 'overissuing': it was caused by the original default. When the norms of honorable dealings between the people and the government are turned upside down, and the dishonored paper is being promoted as money, (that is, elevated from the bottom of the garbage heap to the position of the highest-powered monetary asset of the credit pyramid), then the progressive depreciation of the value of the currency is the natural course of events. First, the dishonored paper goes to a discount in gold. Then, for a time, the discount may move up and down, according to the expectation that reason might prevail and redemption might be resumed. When all hope fades, the inevitable happens. The dishonored paper loses all its remaining value.

The Revolt of Quality

The idea that the monetary regime based on irredeemable currency can endure indefinitely is the stuff of which the dreams of dictators are made. The list of attempts to translate that dream into reality is very long. Yet every one of those attempts in history failed, and did so miserably. There is no shred of scientific evidence that the substance of the present attempt is any different from that of the previous ones. It is true that this experiment has so far survived longer than previous ones. This proves nothing, nor is it necessarily an improvement, for it only prolongs the agony, and makes theend-game even more painful. The paramount fact is that the depreciation of currencies is continuing year in and year out, in good times and in bad, albeit at a varying rate. The linguistic innovation of introducing the euphemism 'price inflation' and the official pretense that monetary depreciation is a 'natural' phenomenon rather than the direct result of dishonorable dealings, will not make the outlook for the present experiment any brighter. Nor is there any reasonable hope that some significant scientific discovery, or a break-through in

data processing and information technology, will change the pessimistic long-term outlook for the regime. It cannot be emphasized too strongly that longevity of a monetary regime is a matter decided not on the basis of the *quantity* of money or the rate at which it is increased, but by the *quality* of assets in the balance sheet of the monetary authority. It is futile to pretend, as the Friedmanites do, that *restricting quantity makes for quality*. Restricting the quantity of a dishonored promise cannot make it more valuable. If the regime of irredeemable currency could be perpetuated, it would be tantamount to the overthrow of the fundamental principle of double-entry book-keeping. This principle demands that an item must appear either in the liability column, or in the asset column of the balance sheet, and it cannot be shifted from one to the other at pleasure. It is not possible to create a liability in the balance sheet of the government and pretend that, by increasing this liability at the 'optimal rate' one can, somehow, increase the assets in the same balance sheet, as the Friedmanites do.

If the revenues of the government consist exclusively of its own liabilities, as is the case today, then the implication is that the citizens are mere slaves of government authority with no power over their own affairs. It means that the citizens, their children, their chattels, their produce, all belong to the government. In order for them to buy food, shelter, medicine, etc., they have to get permission, in the form of a piece of government debt (itself subject to unilateral cancellation) to do so. Elections are meaningless. They are about deciding which party will collect the tithes, not about the question whether tithes should be abolished altogether. The pretense is maintained that the government is in debt to its citizens, and it is the destiny of the debt to be retired. This has no basis in fact. The government debt will never be retired: it is to keep growing indefinitely. It is the citizens who are in fact in debt to the government. It is no longer true that the government belongs to the people: rather, the people belong to the government. In the words of the currency expert, the late Dr. Franz Pick, government bonds are "certificates of guaranteed confiscation". Tax revenues can, in theory, reduce the rate of increase in government debt. However, to the extent that the government wants to translate tax revenues into tangible goods and services, the debt reduction is immediately canceled. In order to have command over real goods and services the government has to borrow, and borrow it must at an accelerating pace. The burden of debt can only be lightened through ongoing currency depreciation. This depreciation must occur in fits and starts. Otherwise people would see clearly what is going on, and would refuse to hold the currency, causing it to lose its value, as it were, overnight.

The unstated premise underlying the regime of irredeemable currency is the proposition that it is possible to keep borrowing with the right hand while destroying the value of the resulting obligations with the left. Governments trying to perpetuate the regime of irredeemable currency will ultimately find that they are destroying their own credit and their ability to borrow in the process. They will, sooner or later, reach the point where they can no longer borrow because they are no longer trusted. This is the revolt of quality. Even with the most drastic quantity controls of money-creation, the destruction of the regime of irredeemable currency is inevitable.

Gold Demonetization

In the late 1960's quantity theorists widely predicted that the de-monetization of gold would seriously undermine the exchange value of gold. Ludwig von Mises[2] was among them: "The important thing to be remembered is that with every sort of money, de-monetization i.e., the abandonment of its use as a medium of exchange must result in a serious fall of its exchange value."

To a quantity theorist, the disappearance of the lion's share of the demand, the monetary demand, couldn't help but make gold cheaper. It is a source of endless amazement for me that a quantity theorist could be so blinded to the other side of the de-monetization coin, namely the effect it has on the irredeemable bank note in which gold is quoted.

It is not known whether these views of the quantity theorists had any influence on the thinking of the decision-makers who demonetized gold on August 15, 1971. Be that as it may, the idea that dishonoring promises to pay gold on demand would, somehow, cause the dishonored paper to go to a premium in terms of gold is preposterous. It is true that insolvent bankers have in the past tried to promote their discredited paper (sometimes using extreme measures such as the death penalty to punish the owners of contraband gold, as proposed by John Law of Lariston and, later, by the issuers of the assignats and mandats), to no avail. *Logic and history prove that dishonored promises to pay gold always and everywhere go to a discount, never to a premium.* Indeed, this is exactly what happened after gold was demonetized world-wide in 1971. In less than a decade the U.S. dollar went to a 90

[2]*Lidwig von Mises, Human Action, p. 428, third edition, Chicago, 1963.*

percent discount in terms of gold. Moreover, the discount was commensurate with the 90 percent loss in purchasing power that the dollar suffered during the same period. There is no use to blame that loss on the conspiracy of Arab sheiks and the gnomes of Zurich. The huge loss in the value of the dollar during the decade of the 1970's was due to one cause only: the de-monetization of gold. The hope that the discount on the dollar would ever disappear is a forlorn one. Domestically and internationally, a deflation of that magnitude is unthinkable. Furthermore, the disarray in America's budgetary and trade accounts suggests that the currency depreciation is likely to continue, if not accelerate. The only way to stop the rot would be the adoption of a reasonable plan to resume gold redeemability of the dollar. Neither party has so far come up with a platform embracing the idea.

The use of the word 'demonetization' in connection with gold is inappropriate. It is but a euphemism for debt-abatement (partial debt-repudiation) inflicted upon the foreign creditors of the United States of America. These foreign creditors were deprived of a valuable property right: the right to a fixed amount of gold per dollar. This unilateral and capricious act has done nothing to benefit the citizens or the government of the U.S. On the contrary, the debt abatement had one predictable consequence: harsher terms on future borrowing, as measured by the higher and unpredictable rates of interest which the government and the people of the United States had to pay on new borrowings abroad. It is true that the burden of debtors who had contracted debt prior to the abatement was lightened but, insofar as they were the same borrowers on whom the harsher terms on further borrowing fell for the indefinite future, there were no beneficiaries, only losers. In particular, the big losers were the taxpayers. The international credit of the U.S. government was grievously damaged as manifested by the unprecedented interest rates (e.g., 16 percent *per annum* on the 30-year bonds) the Treasury was forced to pay on its obligations.

From Greatest Creditor to Greatest Debtor

The stubborn denial that the credit standing of the U.S. has been damaged in any way by the de-monetization of gold of 1971 is the centerpiece of mainstream economics. We must realize, however, that gold de-monetization is just a euphemism for the crime of pauperizing the laboring classes here and abroad, who are the main holders of the irredeemable dollar. Ironically, the 'moneyed classes' have the

habit of holding irredeemable currency for as short a period of time as necessary. Then they get rid of it by investing their funds in something more reasonable.

This is a world of crime and punishment. No one, not even the government of the mightiest nation on earth can exempt itself from the consequences, which are numerous. One of them is the fact that, in an incredibly short period of time, America turned itself from the world's greatest creditor into its greatest debtor country. Another is that that part of the American industry which is not in the process of dismantling itself, is losing international competitiveness, just at the time the country would need a strong export industry to help pay for its burgeoning foreign debt. Due to volatile interest rates in the 1980's, a large part of America's park of capital goods has become submarginal. Producers were either unwilling or unable to maintain capital by replacing worn and obsolete equipment with new ones. As capital was becoming submarginal under a rising interest-rate structure, so were the producers. They were forced to sell their business at a loss, and invest the proceeds in high-yield Treasury bonds. This was a textbook-case how the government can despoil its own taxpayers. In printing high coupon-rates on Treasury bonds, instead of collecting taxes from the productive members of society, the government is now obliged to pay them for holding its debt. A large segment of the producers found themselves unable to compete with the high coupon rates the government so cavalierly printed on its bonds and, from producers of new wealth they became coupon-clippers. The consequences of wholesale destruction of capital are camouflaged by the burgeoning import of consumer goods. Foreigners accept the dollar for the time being, as in their judgment the dollar was depreciating more slowly than their domestic currency. Such a situation cannot continue indefinitely. The most visible sign of the progressive deterioration is the ever-growing trade deficit, the flip-side of the accumulation of U.S. Treasury paper in foreign hands. At one point, the world market will get saturated with the U.S. dollar. When that happens, another convulsion in the world's commodity and financial markets will follow.

It is not widely understood that the dollar was given a stay of execution by the fortuitous demise of the Soviet Union and its Evil Empire in 1990. This unforeseen historic event turned the dollar-glut into a fresh dollar shortage. All of a sudden a new market, counting some 400 million souls, was thrown wide open to dollar-penetration a market that had earlier been hermetically sealed off by the threat of the firing-squad. Huge though this market for dollars may appear, it is not unlimited. At one point it would also become saturated as had markets in

Western Europe done in the late 1960's. It is no use predicting that the present dollar-shortage would never turn into a dollar glut. Similar predictions were also made during the dollar-shortage of the 1950's at a time when America's trade advantage over the rest of the world appeared unassailable. When the dollar-glut of the late 1960's hit the unsuspecting world, those predictions were totally discredited. Today America's trade position is incomparably weaker, and getting weaker still. And, remember, America is no longer the world's greatest creditor. Now, it is the world's greatest debtor. Accordingly, the effects of the dollar glut, when it comes, will be that much worse.

The Swing of the Wrecker's Ball

Another great danger has unexpectedly appeared on the horizon, the blackhole of zero interest. It turned out that the volatility of interest rates, that was unleashed through the demonetization of gold, also has a long cycle measured in decades. At first, the pendulum was swinging towards infinite interest, threatening the dollar with hyperinflation. Right now the pendulum is swinging to the other extreme, to zero interest, spelling hyper-deflation. This is just as damaging to the producers as the swing towards infinite interest was in the early 1980's. It is impossible to predict whether one or the other extreme in the swinging of the wrecker's ball will make the world economy to collapse. Hyperinflation and hyper-deflation are just two different forms of the same phenomenon: credit collapse. Arguing which of the two forms will dominate is futile: it blurs the focus of inquiry and frustrates efforts to avoid disaster. In the meantime, the wrecker's ball keeps swinging, with ever wider amplitude, and ever greater force.

The credit of the U.S. government suffered its greatest setback in history, as a result of the 1971 devaluation of the dollar, even though it was only by a relatively insignificant amount (the official price of gold was increased from $35 only to $38). The deterioration of the credit of the U.S. still continues, with unforeseeable consequences. This is not generally acknowledged by financial writers at home and abroad. The gross mismanagement of credit in the U.S. and in the rest of the world has created intractable problems for which there are no painless solutions.

Such are the consequences of the confusion between present and future goods, between capital and credit, between assets and liabilities deliberately fostered in the minds of the people by the proponents of mainstream economics.

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The Transition From Direct to Indirect Exchange

Don Lloyd of Peabody, Massachusetts, writes that I got the meaning of Mises wrong when I referred to the individual rearranging his scale of values in response to direct exchange being abandoned and replaced by indirect exchange (Lecture 8, Mises by North). Suppose that he preferred apples to oranges under direct exchange but, with the advent of indirect exchange, he finds that he reverses his preferences. The price of an apple being $6 and that of an orange $4 apiece, Don says that the difference in price, $2, affords him enough extra market power to make the change worth his while. In contrast to my suggestion, that the individual would rearrange his scale of values to *conform* to the prevailing constellation of prices, he has rearranged his to *oppose* it.

Don, I appreciate your comment. Here is my answer. Apart from the fact that the changeover from direct to indirect exchange took hundreds if not thousands of years (so that no individual could observe the entire process), under indirect exchange you are no longer comparing apples and oranges. You compare one apple to one orange *plus* something you can buy for $2, say a plum. In other words, you haven't changed your preference for apples at all. One apple still ranks higher in your scale of values than one orange. The new element is that you can now *measure* the difference in values; you can actually *subtract* one value from another.

Your example does not weaken my position, it confirms it. Not only does the advent of money and prices give you everything you have had before (namely the possibility of ranking), it gives you more (the possibility of *measuring*). You can now answer the question by *how much* you prefer one apple to one orange. You always rank the more expensive item higher in your scale. You don't always buy what you value higher, but if buy the cheaper instead, then it is because of your preference for saving the difference. It is a very common human experience to have to make do with the cheaper item, in spite of our preferences.

It is not enough to say that you oppose the valuation of the market. To give substance to your valuation, you have to do something about it. This is what the entrepreneur does, in going into production to bring down the price that, in his opinion, the market values too highly. Indeed, I am not saying that *all* individuals *always* conform their scale of values to the constellation of prices. On the contrary: the exceptions are enormously important, or should be, to an Austrian economist. These exceptions explain the origin and nature of entrepreneurship to us. The entrepreneur *dares* oppose conventional wisdom as he posits his own valuation against that of the market. If he values A less than B but finds that in the markets $a > b$ (A is more expensive than B) then he will resort to arbitrage. This may take different forms, but the one that is important for our purposes is the entrepreneur's. He goes into the production of A using new materials, new production technologies, or even opening up new markets for A, so that he can bring a down and earn entrepreneurial profits. Please note that it is not only his entrepreneurial insight that serves as the source of those profits, but also the monetary economy which has helped him to spot an anomaly. Entrepreneurship has become easier under indirect exchange precisely because the entrepreneur can *measure, add, subtract, multiply and divide* values, none of which were impossible under indirect exchange.

Subjective economists, of course, have realized the great significance of the revolution represented by the transition from direct to indirect exchange. Nevertheless, they have failed to deal adequately with the aspect how this transition affected the subjective valuation of individuals. Ludwig von Mises devotes three sentences to this in *The Theory of Money and Credit*:

> *"Nowadays exchange is usually carried on by means of money, and since every commodity has therefore a price expressible in money, the exchange value of every commodity can be expressed in terms of money. This possibility enabled money to become a medium for expressing values when the growing elaboration of the scale of values which resulted from the development of exchange necessitated a revision of the technique of valuation. That is to say, opportunities for exchanging induce the individual to rearrange his scale of values."*
> *(Op. cit., p. 61.)*

I submit that this "rearranging of values" was, in fact, a revolution in the subjective valuation of goods by individuals. The market *harmonized* subjective individual values, by codifying them in the price structure. As a result, values were lent the appearance of being 'objective'. It may appear that subjective individual values were made to conform to 'objective' values as manifested by prices. Of course, we know that subjective values had been first, and they were synthesized into prices, so we still talk about 'subjective theory of value'. The harmonization of scattered individual values into the constellation of prices was a revolution of the utmost significance. Among others, it was responsible for the change that entrepreneurs started using *market calculation*. They could not have done it without being able to measure the value of goods and services.

Thank you, Don, for your stimulating observations. I hope you will eventually agree with me that this is a point where Austrian economists could carry science further.

Chapter 11

The Acceptance House

(Lecture Eleven)

Illicit Interest Arbitrage - The Second Greatest Story Ever Told, Chapters 10 and 11 - The Discount Rate/Interest Rate Spread - Borrowing Short to Lend Long - Anticipation and Accommodation Bills -

Illicit Interest Arbitage

There was nothing sinister about the appearance of the Discount House, as a precursor of the bank. Nor was there anything suspicious about the bill of the goldsmith, as a precursor of the bank note. Fraud came later, as the story of the bill of exchange unfolded, and illicit interest arbitrage and the practice of borrowing short to lend long appeared and spread.

The villain of the piece is the Acceptance House, as we shall see, another (and this time quite sinister) precursor of the bank. The Acceptance House conspired with impostors in order to put fictitious bills of exchange into circulation. As long as these fictitious bills remained in the public domain, with due diligence, the fraud could be exposed. But soon enough some banks joined the conspiracy and started sheltering the fictitious bills in their portfolio of assets. For the Acceptance House and the conspiring banks this was a lucrative business. It allowed them to pocket the spread between the higher interest rate and the lower discount rate, to which they were not entitled. They wanted to profit but without taking risks. Not only did they take no risks, neither did they provide a service to society that might have justified the profit. The business of selling fictitious bills against buying bonds is

called illicit interest arbitrage. It means borrowing funds in the bill market at the lower discount rate and peddle them in the bond market at the higher interest rate. The arbitrage is illicit, as we shall see it in full details later. It is a case of extortion. It is fraudulent as it involves misrepresentation and non-disclosure. The scheme of illicit interest arbitrage would collapse if transparency of business transaction were maintained and safeguarded. Now I return to *The Second Greatest Story Ever Told.*

Chapter Ten

(in which the gentle reader learns why the miller and the baker were blacklisted at the Discount House)

One day the manager of the Discount House noticed that a bid/asked spread appeared in the trading of the miller-on-baker bills. Buyers consistently bid a lower price than that asked by the sellers of these bills. Normally, there was no spread in bill trading. A bill with two good signatures could be bought and sold back-to-back, often at the same price. This is explained by the fact that the bill was an appreciating asset. Its value increased daily as the date of maturity approached. A bid/asked spread, whenever it appeared, suggested trouble. It indicated that there were too many of that particular bill around, discouraging buyers.

The manager of the Discount House suspended the trading of the miller-on-baker bills, waiting for the situation to clear itself. Soon it turned out that the miller had conspired with the baker in putting bills into circulation supposedly representing flour on the move to the bread-consuming public. In fact, however, there was no flour and there was no movement. There was only grain sitting in the miller's bins, held back by the miller in hope for an increase in the grain price. The miller and the baker were speculating that the poor harvest could create a shortage causing higher prices in the grain market, from which they wanted to benefit. They were trying to finance their speculation by drawing miller-on-baker bills representing the grain withheld from consumption, sitting in the miller's bins.

The speculation ended in a fiasco. The miller's and baker's expectation of much higher grain prices didn't materialize. They 'rolled over' their credit, that is, they

paid the maturing bill by drawing another on the same grain holdings. This was a very serious violation of the statutes of the bill market, because the limitation of 91 days on the maturity of bills was absolute. Under no circumstances must the bill on the same goods be redrawn.

In the meantime, the bill market grew less accommodating. As the fraudulent miller-on-baker bills were in addition to the regular ones supporting the supply of the consumer with bread (that is, on merchandise that did indeed move) a bid/asked spread appeared. When the Discount House suspended trading the miller-on-baker bills, the conspirators were squeezed. In order to extricate themselves from their situation they threw their grain on the market. The forced sale of such an abnormal quantity of grain temporarily depressed the price. The conspirators wound up their ill-fated speculation with a huge loss. In the end, they defaulted on some of their bills at maturity.

Default by merchants on their bills was exceedingly rare. Even loss of cargo at sea was no occasion for default. A bill drawn on merchandise in the bottom of vessels had to be accompanied by insurance certificates showing that the merchandise at sea had been insured to the extent of the full face value of the bill. In case of loss at sea the insurer would pay the bill at maturity.

If a merchant defaulted for reasons of personal financial tangles, then he could never again hope to discount a bill in his life. Nor could his sons. Their name was to remain on the blacklist for several generations. Being cut off from the bill market meant that the lifeline of the merchant was severed, as it were, his trading capital was confiscated. The merchant found himself out of business. This was exactly the fate awaiting the miller and his accomplice, the baker.

Speculation in Agricultural Commodities

It is important to understand that there is nothing wrong per se with speculating in agricultural commodities. As long as the speculator is using his own funds, or legitimately borrowed money for this purpose, no one has the right to criticize him. But the miller and the baker in our story tried to use the bill market for the purpose of financing speculative stores. This is definitely wrong. The bill market

is strictly for merchandise that moves, moreover, move it must fast enough to reach the cash-paying consumer in less than 91 days. It is fraudulent to represent that the merchandise held back for speculative purposes moves since, in fact, its movement has just been arrested.

Most tradesmen are sensible people realizing that, while speculation in agricultural commodities is a legitimate business, it must be financed properly. *The speculator has no right to shift his risks onto the shoulder of society.* For this is exactly what is involved in drawing bills on merchandise sitting in speculative stores waiting for a price-rise. The bill market, as we well-know, is a *clearing system.* It can only work if each bill faithfully represents the underlying transaction, and if the merchandise is moving as specified on the face of the bill. Accordingly, each bill is scrutinized by the market not only in regards of the credit standing of the drawer and the acceptor, and every subsequent endorser, but also in regards of the transaction represented on its face. Dubious bills, or bills which appear to be over-abundant, are rejected.

The miller and the baker did not try to defraud any particular individual. In drawing bills under false pretenses they tried to defraud the general public. They pretended that the underlying merchandise was moving and would reach the ultimate consumer in 91 days when, in fact, they were responsible for arresting the flow of goods. In doing so they were not merely hoping for speculative profits. They were also trying to shift the risks from their shoulders to the public at large. They wanted to pocket the difference between the higher interest rate and the lower discount rate. They would justify this as profits for shouldering risks. But they passed their risks on to the public. It is clear that they were not entitled to those profits.

The conspiracy of the miller and baker is an example of what we shall call illicit interest arbitrage. More generally, the term refers to arbitrage from the bill to the bond market. As interest rates are generally higher than the discount rate, the temptation is constantly present for tradesmen with ready access to the bill market to use bills for illegitimate purposes, such as selling them to invest the proceeds in bonds. Illicit interest arbitrage is a crime against the general public, the same as the crime of forging public documents. Indeed, the bill of exchange is a public document, and false statements on its face must be treated as fraud. (Note that arbitrage in the opposite direction, from the bond to the bill market is not illegitimate. Such action is profitable in the rare and abnormal case when interest

rates are pushed below the discount rate. For this reason, it is called 'natural interest arbitrage'.)

The market tends to expose illicit interest arbitrage, as it exposed the conspiracy of the miller and the baker. But in so far as the conspiracy remains unexposed, the public at large is victimized in the form of higher prices.

Anticipation Bills

Chapter Eleven

(in which the gentle reader learns how the miller and the baker went on the warpath to strike back by establishing the Acceptance House.)

Many years have gone by, but they couldn't remove the bitterness of the miller and the baker over their humiliating failure. They felt that in being blacklisted at the Discount House they have been unjustly victimized. They thought that they were the 'misunderstood innovators'. They were plotting to take a revenge. Their opportunity came when the manager of the Discount House died, leaving his business to the elder of his two sons. The other son, known by the nickname Prodigal, did not inherit any part of his father's business nor, apparently, his acumen and integrity. The miller and the baker moved to befriend him.

"Your inheritance is more valuable than you realize, if you had eyes to see your fortune", the baker said to Prodigal. "Your name is spelled in gold. Let me show you how you can pan it. You should start a business of your own." But Prodigal pleaded poverty; he has already spent his patrimony. He could not put up the capital. "Never mind capital", retorted the miller. "We shall teach you a new creative way to start a business with no capital."

The young man may have been prodigal but he was not stupid. "Why don't you start your own business if you know how to do it without capital?" he asked. The baker explained, sotto voce, *that you need a name with high recognition value to do that. Prodigal was the scion of a merchant family that has been in business for over two hundred years, the last fifty of which in discounting. It had an impeccable name and enjoyed the respect and admiration of everybody. "You contribute your name,*

and we contribute the expertise", the baker cajoled him. "You don't even have to work if you don't want to. We give you 50 percent of the profits. My friend, the miller and I will be satisfied with 25 percent each."

The offer was too good to turn it down. The 'enterprise' was called the Acceptance House. It would take business turned down at the Discount House. It would endorse - or to use the resurrected word, 'accept' - any bill presented to it, provided that two conditions were met. (1) The bill should have an air of demure respectability in referring to some goods about to be shipped. For this reason it was called an anticipation bill. (2) The face value of the bill should be posted as a collateral security in the form of mortgages on real estate or bonds. The Acceptance House was entitled to liquidate the collateral in case of a default by the drawer of the bill, but would return it upon payment of the bill in full at maturity. In addition, the Acceptance House stood ready to roll over the credit facility indefinitely upon advance mutual agreement.

Now the operators of the Acceptance House were in the position to bilk the general public out of its funds by taking advantage of the positive spread between the interest and discount rates. In effect, they were selling bills and buying bonds with the proceeds, pocketing the difference, while taking no risk at all. At any rate, that's what they thought.

Accommodation Bills

The essence of the bill of exchange is that salable goods are moving to a place where there is a ready demand and market for them. The reason for making it payable at a later date is to allow for shipping and ultimate disposal, including the time needed for garnering the proceeds of the sale. The act of acceptance makes the bill of exchange immediately negotiable or convertible into cash through discounting. The bill had the advantage of 'paying itself'. The goods on which the bill was drawn, being certain of a market, are the guarantee to the bill's holder that "he is not holding the bag" containing nothing. The anticipation bill, promoted by the Acceptance House, was very different. The underlying goods did not move, and there was only a vague understanding that they eventually might. The sale of merchandise to the ultimate cash-paying consumer by the maturity date could no longer be taken for granted. On the contrary: it was a foregone conclusion that the

anticipation bill would have to be redrawn and redrawn again, at the end of each 91-day period. That redrawing bills was a dubious practice was already pointed out by Adam Smith. Even worse was the practice of drawing accommodation bills. These were bills drawn on fictitious goods shipped to fictitious vendors. But the impeccable name of the Acceptance House made them as good as cash, regardless of the fraud involved in drawing them.

Debauching Accounting Standards

Banking has grown out of two separate roots: the business of the goldsmith, and that of the Acceptance House. The latter is the bad guy. Here is a conspiracy between the borrower and the Acceptance House with ready access to the bill market. Once the fraudulent anticipation and accommodation bills are removed from the bill markets and given shelter in the portfolio of the bank, then whatever possibility for the detection of the fraud had existed before was lost. The practice of shortchanging the public could be perpetuated.

The banks could create something out of nothing only through the fraud of accepting anticipation and accommodation, disregarding the fact that these bills were no longer self-liquidating. The banks could not care less how the borrowers would eventually get the money to repay the loan. In case of a default the bank would liquidate the collateral and satisfy itself from the proceeds.

The banks were in fact usurping and monopolizing social circulating capital. They could get away with it by virtue of the government patent exempting banks from the rigors of bank examinations and from the strict application of accounting standards. The banks could carry their assets at arbitrary values. They said it was their business and nobody else's.

Before the government exempted the banks from the provisions of contract law, strict accounting standards had been in force reflecting the desire to protect the public from the consequences of conspiracy such as (1) declaring bankruptcy fraudulently (by representing assets at artificially low values) or, its more common counterpart, (2) window-dressing the balance sheet fraudulently in an effort to stave off a run on the bank (by representing assets at artificially *high* values). Honest accounting demands that the bank carry assets either at historical cost or at market value, *whichever is lower*. The government patent protecting the banks has resulted in permitting the banks to carry assets either historical cost or at

market value, *whichever is higher*. Non-disclosure or misrepresentation of the true state of affairs is, of course, a crime against the public interest. But the banks were protected against prosecution by the patent the government has given them.

The profession of chartered accountants and bank examiners ought to stand guard over the integrity of balance sheets and the quality of assets of the banking industry. But it has long since departed from this ideal. Accounting codes and norms have been changed in order to suit the interest of the government, as opposed to the interest of the public. The government has become an accomplice in the fraud and a party to the conspiracy against the public. The government, in betraying its sacred mission of standing guard over the public interest, is motivated by its consuming passion to have its own debt monetized through the banking system.

Neither the government, nor the banks, nor the accounting profession will be able to escape responsibility for compromising accounting standards and for corrupting the profession of accountants and bank examiners, when the day of reckoning finally dawns. The present exercise of a witch-hunt to charge producers with accounting crimes is hypocritical in the extreme. The government should come clean of its own accounting crimes first.

The Two Categories of Bank Assets

Illicit interest arbitrage in modern setting manifests itself through certain practices of commercial banks. Economists have failed to make a distinction between bank assets representing goods *on offer for sale* and others representing goods *not on offer for sale* in the markets. This distinction between the two types of bank assets is fundamental. The value of those of the first category is faithfully reflected in the balance sheet, as the market is continuously testing these values against existing and changing marginal utilities. In case of any discrepancy, correction is instantaneous and automatic. The same, however, is not true of assets of the second category. Here the balance sheet notoriously *overstates* values. These assets are sheltered from the trials and tribulations of the market place. They are protected against wear and tear due to the ravages of declining marginal utility, brought about by repeated market test.

For example, a house that is being built for the housing market by the contractor is on offer for sale, and a bridge-loan against it is a bank asset of the first category.

By contrast, a home equity loan is a bank asset representing an item, your home, which is not on offer for sale (you hope) and, therefore, it is a bank asset of the second category. The seeds of a credit collapse are sowed by the banks themselves in loading their portfolio with assets of the second category. When the crunch comes, these assets are thrown on the market simultaneously and indiscriminately as the banks scramble to regain solvency. The market, which follows the law of declining marginal utility (rather than the wishful thinking ofover-confident bankers) refuses to validate the fancy values at which these assets are carried in the balance sheet. The day of reckoning has dawned. The banks are confronted with the truth, and they are forced to absorb huge losses.

The practice of carrying assets of the second category is just another instance of illicit interest arbitrage. Once the banks usurp control over social circulating capital, they can borrow at the lower discount rate and peddle these funds at the higher interest rate to their clients. They can make this practice look legitimate with the connivance of the bank inspector who is trained to "hear no evil, see no evil, say no evil". But this activity cannot go on forever. Depositors who can read balance sheets will move their business from the illiquid bank (indulging in illicit interest arbitrage to a greater extent) to a more liquid bank (indulging in the practice to a lesser extent). The depositors' arbitrage (known in banking circles as 'disintermediation') will squeeze the illiquid banks. The liquidation that follows spawns the boom-bust cycle. It may take down sound businesses along with the shaky ones into bankruptcy. This reveals the most evil aspect of illicit interest arbitrage. Along with the guilty, the innocent is also made to suffer.

The key to preventing the boom-bust cycle is not to allow banks to carry assets of the second category in excess of capital accounts. Bank assets of the first category include gold (as all gold above ground is deemed to be on offer for sale under a gold standard) as well as bills of exchange drawn on goods that will be sold to the ultimate cash-paying consumer in less than 91 days. *These bills are the most liquid earning assets that a bank can have.* By contrast, assets in the second category are not liquid. They include stocks, bonds, mortgages, finance and treasury bills, or loans collateralized by these. Unlike self-liquidating bills, they are all subject to great fluctuations in value. In case of forced liquidation (for example, when a number of illiquid banks are scrambling to get liquid) all bids for them may be withdrawn, creating a panic.

But if all banks limited their portfolio to assets of the first category, then no runs and panics could occur. Even unusually large cash-withdrawals could be met

without forced liquidation of assets. As one bank experiences cash-withdrawals, another with surplus cash will be eager to buy the bills of the former. At any rate, more than one-ninetieth of all banking assets backing sight liabilities is maturing every day, obviating the need for asset-liquidations. If the cash-shortage was brought about events outside of the control of the banks, such as natural disasters (e.g., crop failure, flood or earthquake destroying property), then the banks can adjust smoothly to the changing circumstances by discounting fewer bills during the construction period. It is virtually impossible that all bids for bank assets of the first category be withdrawn simultaneously. Shortage of cash here always results in a surplus of cash somewhere else. The latter will then start scrambling for liquid earning assets such as bills of exchange.

Crime and Punishment

This is a world of crime and punishment. The crime of illicit interest arbitrage cannot avoid receiving its just punishment eventually. It makes the positive spread between the interest and the discount rate vanish. This undermines not just the lucrative monopoly of the banks, but also the entire financial system. When the discount rate catches up with and surpasses the rate of interest, panic in the credit market will ensue. Bids for bonds are withdrawn. Bond prices will collapse, and the rate of interest will shoot up. This will render much of the productive capital of the country sub-marginal, causing depression.

Earlier I have quoted an old saying on Lombard Street that the easiest business in the world is banking, provided that the banker can grasp the difference between a bill of exchange and a mortgage. If bankers occasionally flunked this test in the 18th and 19th century, bankers in the 20th did not even understand what the fuss is all about. They shrug off the criticism. An asset is an asset is an asset … Money doesn't stink. It has no quality outside of its quantity. Ghosts that used to haunt bankers in their sleep, such as assets of dubious quality in the balance sheet, have been interned for good, thanks to government-administered safety nets.

However, it is doubtful that governments can legislate business risks and asset quality out of existence. The qualitative difference between a genuine bill of exchange and a mortgage cannot be denied (securitization of the latter notwithstanding). The former is easily negotiable before maturity without bribe or blackmail. At maturity it is cash by the sale of goods on which it is drawn. No safety net and

no coercion is needed to promote its circulation. The latter is by no means readily negotiable. Mortgages or loans on real estate require two expensive and time-consuming processes: surveying and title search, before they can be transferred. Moreover, the real estate market, just as the bond market, could get demoralized as a result of the withdrawal of bids. The market in self-liquidating bills could never seize up the same way.

The quality of an asset cannot be improved by burying it deep inside of a bank's balance sheet. Non-disclosure and misrepresentation can only damage assets. For this reason, illicit interest arbitrage is even more dangerous when practiced by banks. The conspiracy in which the Acceptance House engaged was bad enough, but at least the dubious assets stayed in the public view. The bill market was still a level playing field, and the Discount House was still acting as an umpire, blowing the whistle whenever fair play was put in jeopardy. There was a feed-back which prompted self-correction, in so far as the quality of credit was concerned. No more. Commercial banks have removed the dubious assets from public view, sheltering them in their balance sheet. The public is no longer in the position to scrutinize those assets, and is powerless to prevent further deterioration in the quality of credit. Bank assets are diluted, and theself-correcting mechanism of the credit market is short-circuited. The effect is a cumulative deterioration of bank credit. When credit collapse finally comes, it will be all the more devastating. Recovery will be more painful and take longer.

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Small Is Beautiful After All?

Don Lloyd of Peabody, Michigan, comments on Mises' position on bank notes of small denomination (re: Lecture 9, "Small Is Ugly"). He disputes that there is a misprint on p. 494 of *The Theory of Money and Credi*t where Mises calls for the issuance of bank notes in denominations of one dollar, fifty dollars, and upwards. In other words, Mises thought it was admissible to issue bank notes of small denomination, in spite of objections of English authors finding the issuance of small bank notes detrimental to the interest of the working classes.

My own interpretation is that Mises was convinced that in the interest of the preservation of the gold coin standard he was advocating, and for the protection of the working people who would be cheated out of their possession of gold coins by small bank notes, the issuance of such notes should not be authorized. However, if Mises really meant that one dollar bank notes be circulated under the new gold coin standard he was describing, then he would appear to be condoning the practice of withholding gold coins from the working classes. I would regret it if it was true. At any rate, I think more research into the question of Mises' attitude with reference to bank notes of small denomination should be carried out to clarify this point.

Money and Morality

One of the recurring themes of this lecture series is money and morality. Therefore it was very rewarding for me to receive the following message from Carl Luxem, Jr .

Dear Professor:
I have been reading your lectures at gold-eagle.com. They bring to mind something one of my mentors told me years ago, namely, that They said it was their business and nobody else's. God designed life so that it does not work without Him, nor without the order He established for it". Given how far the world has departed from the economic order you are describing, I expect the coming reality shock to be quite devastating. Your attempts to warn and educate us about the evil inherent in the present system are admirable. I have tried to do the same with some success

by viewing the problem from a moral perspective. I deeply appreciate your work because, as a money manager and a student of economics, it has been a long time since I have been able to find anything that makes as much sense as your lectures. Sincerely, etc.

Carl, I think we are getting through. Just keep up the good fight.

Chapter 12

Borrowing Short to Lend Long

(Lecture Twelve)

The Second Greatest Story Ever Told, Chapter 12 - The Interest/Discount Spread - Non-Disclosure, Misrepresentation, Lack of Transparency - Self-Liquidating Loans - In Praise of Scholasticism -

Chapter 12

(in which the gentle reader learns why the miller and the baker did not succeed to commit the perfect crime)

Having burnt their fingers once before, the miller and the baker proceeded very cautiously. They understood very well the inherent danger that the bill market may reject their anticipation and accommodation bills. Therefore they insisted that their customers post collateral security.

"We can now print our own money" gloated the miller. "When we accept accommodation bills, we borrow at the lower discount rate in order to lend at the higher interest rate. We simply pocket the difference between the two. It's manna from heaven." The baker added gleefully: "And if our customers fall upon hard times and can't pay their debt, no harm done. We shall pay on their behalf out of the proceeds of their collateral."

The miller and the baker went on creating bills merely for the sake of discounting them, and so to provide their customers with ready cash, and themselves with an

income. In order to make these accommodation bills more attractive to the prospective buyer, they invented goods and sent them on imaginary trips around the globe. They thought that chances of exposure of the fraud were nil. They would never ever allow their customers to default. Should they be unable to pay, the Acceptance House would routinely pay off their debt at maturity without demur, and get compensated by selling the collateral. Whenever the market value of the collateral fell, the Acceptance House would issue a 'margin call', that is, a call to restore market value to the original level by posting more collateral.

For a time it looked as if the baker and the miller have indeed succeeded in inventing the 'perfect fraud'. The sky was the limit to the profits to be made in the acceptance business, as only human imagination could limit the type of goods to be invented for the purpose of discounting. Alas, there was a fly in the ointment. What the baker and the miller forgot to consider was that their profit depended on a positive spread between the interest rate and the discount rate. But their activities were undermining exactly this foundation. As more and more fictitious bills were put into circulation, the spread narrowed. The Acceptance House was forced to accept ever more fictitious bills in order to maintain its customary profit margin. This, of course, made the spread to narrow further. Clients were caught up in the squeeze and were forced to forfeit their collateral. The burden of the fraud was shifted to the mortgage market and, ultimately, to the real estate market.

One day the miller came home with bad news: "You can buy real estate as cheap as stinking mackerel", he said to the baker. "We had better liquidate all the mortgages in our portfolio before the owners walk away from their properties." But it was too late. There were no more takers for first mortgage on prime commercial real estate than for a third mortgage on a farm in the moon.

The Acceptance House, too, was forced into liquidation. The conspiracy of the miller and the baker collapsed once more. The worst aspect of the disaster was that it victimized a lot of innocent bystanders, owners of real estate who had nothing to do with the fraud and the conspiracy, but who nevertheless suffered real losses because of it.

It is clear that accepting anticipation or accommodation bills amounts to illicit interest arbitrage. The drawers of these bills should properly go to the

bond (i.e., loan) market and borrow at the prevailing rate of interest, making full disclosure to the lenders about the nature of their enterprise. Instead, they went to the Acceptance House where full disclosure was not a requirement. In this way they could keep their cards closer to their chest and escape scrutiny as to the nature of their business, as well as control that lenders would normally want to exercise over the activities of their borrowers. For its part, the Acceptance House welcomed this business because of its great profitability. It pocketed the spread between the rate of interest and the discount rate without assuming any risk, indeed, without rendering any useful service to society (such as the Discount House does).

Borrowing Short to Lend Long [1]

More generally, it is illegitimate to borrow short in order to lend long. To do so is tantamount to making unwarranted assumptions about future market and credit conditions. There is no way to predict what the consumer will demand most urgently in the future, nor to predict what items will fall out of his favor. There is no way to predict how tight credit conditions will be.

There are those 'free market economists' who call the denunciation of borrowing short to lend long a witch-hunt. They say that the practice cannot be condemned on economic grounds, any more than risk-taking can. "Let competition prevail", they argue, "and let the smartest guy win the jackpot!" They call our criticism, at best, a moral judgment; at worst, an effort to stifle competition. It is not for the economist to make moral judgments on what is and what is not an acceptable level ofrisk-taking.

There is no need to quarrel with the last statement. But to say that the case against borrowing short to lend long has nothing to do with economics shows a profound lack of understanding of the market process. It should be clear that the dispute is not about risk-taking. The proposition that borrowing short to lend long ought to be outlawed does not aim at stifling competition, any more than the proposition that misrepresenting the quantity or quality of goods offered for sale ought to be outlawed does. Economics does not criticize speculation and other

[1] *Borrowing Short and Lending Long: Illiquidity and Credit Collapse, by A. E. Fekete, CMRE Monograph Series No. 38, 1984. Committee for Monetary Research and Education, 10004 Greenwood Court, Charlotte, NC 28215-9621, United States, FAX:(704) 599-7037.*

forms of risk-taking as long as risk-takers use their own funds, or they persuaded someone else to advance funds for this purpose.

Social circulating capital is not owned by any individual, nor by any group of individuals. It is communal property, as it were. It is property 'socialized' in the best sense of the word. The flip-side of social circulating capital is the bill market. To dip into the bill market in order to raise funds without contributing anything in return is the same as stealing communal property. Just what is a valid contribution to social circulating capital and what isn't, is a question that is decided by the bill market. If the bill, making full disclosure without misrepresentation, can be discounted at the going rate, then the underlying good belongs to the social circulating capital; otherwise it doesn't. Bills that can be so discounted are capable of monetary circulation; others aren't. This is an objective criterion setting apart self-liquidating bills from anticipation, accommodation, and other fiduciary bills. There is no appeal against the verdict of the market. There is no scientific argument that could overrule it. We may assume that according to the most authoritative scientific research "miracle product X" ought to have a place in everybody's household. But, unless this opinion can convince consumers, product X will not be part of the social circulating capital, and bills drawn against it just won't circulate. The bill market is the final arbiter on that matter. However, all statements on the face of the bill must be true to fact and to intention. Otherwise the bill is disqualified and becomes phony, and the drawer and acceptor become impostors and counterfeiters. They should be subject to the same punishment reserved for the conspirators in coin-clipping and forgery of bank notes.

Baring Brothers

The textbook example of the fate of the Acceptance House guilty of illicit interest arbitrage is the collapse of the House of Baring in 1890. The firm Baring Brothers & Co. was established in 1763 in London by John and Francis Baring. They were the sons of John Baring (1697-1748), a successful German cloth manufacturer who in 1717 started a small business in Devon. At first the partners were import and export commission agents for other merchants, but they soon began to lend their credit in the form of trade acceptances. They were involved in financing the British war effort against revolutionary France and, later, that of the Union against the Confederacy in North America. In 1890 the firm was still controlled by the Baring

family when it got involved in Argentinean and Russian government finances and collapsed. Baring Brothers & Co. was bailed out by the Bank of England. However, as an Acceptance House, the firm's credit was effectively ruined. See *The House of Baring* by R.W. Hidy published in 1949.

The Interest/Discount Spread

If the market knowingly discounted undisguised anticipation and accommodation bills at the same discount rate as that applicable to real bills, then there would be no basis for objecting against these fiduciary bills. But clearly this is not the case. Undisguised accommodation bills would never circulate. Disguised accommodation bills may circulate for a time, thanks to the conspiracy of the Acceptance House and its clients but, as a rule, the fraud will come to light sooner or later. The charge of non-disclosure, fraud, and misrepresentation concerning the nature and the status of goods on the face of the bill stands.

The positive spread between the interest and the discount rate is not there for the picking. It is there to support social circulating capital. Supplying the consumer with urgently needed goods on the shortest possible notice and in the most efficient manner would become prohibitively expensive, were it not for the presence of the spread. Bread and milk would have to be supplied on the same harsh terms as the surgeon's knife and the watchmaker's precision instruments. The publisher of newspapers would have to apply the same mark-up as that of a Sanskrit grammar. Indeed, milk, bread, and newspapers are perishable. Incentives to produce and distribute them for the benefit of society are absolutely essential. Of course, we don't mean subsidies. We mean the spontaneous incentive embodied in the undistorted spread between the interest and discount rates.

Damages caused by natural disasters, for example, would be far harder to heal (and, hence, far more devastating) in the absence of a positive spread. The productive apparatus of society would be less efficient, more wasteful, and less responsive to changes in the absence of a positive spread between the interest and discount rates. It should be evident that the market needs safeguards against illicit interest arbitrage causing the spread to vanish, much the same as it needs safeguards to prevent any other form of fraud. Alas, it was not done in the heyday of bill-trading and of the gold standard, before the outbreak of World War I. Illicit interest arbitrage should have been outlawed, and fraud in bill-drawing punished. It should have

been enshrined in legislation governing the bill market that drawing anticipation and accommodation bills is tantamount to falsifying public documents and, as such, constituted fraud. This would have put the Discount House in a stronger position to detect and expose fraudulent bills. The Acceptance House could no longer safely accept bills known to carry false statements on their face. This is not just a legal and moral problem. It is also one of economics. It is most unfortunate that the economists' profession contributed nothing to its solution. It took the 'see no evil, hear no evil' attitude, leaving the problem to solve itself 'through competition'. It ignored the fact that fraud lends an unfair advantage to its practitioners, and it was futile to expect that competition could purge business of crooked practices.

The position of the Austrian School, inspired by Mises, suggests that credit expansion by the banks (which we could identify with the acceptance of anticipation and accommodation bills) would be forestalled by the institution of 'free banking': the best-managed banks would survive. It is a strange way to handle fraud in letting competition take care of it. The Austrian School must recognize the presence of fraud in credit expansion. The reason that it has failed to do so is its superstitious adherence to the Quantity Theory of Money, and its mindless rejection of the Real Bills Doctrine of Adam Smith.

Non-Disclosure, Misrepresentation, and Lack of Transparency

We should realize that the problem has become worse, exposure of the conspiracy made more difficult, and the watershed between upright and fraudulent business conduct further obscured when the banks started emulating practices of the Acceptance House. As we know, earlier the banks emulated the practices of the Discount House. So long as they confined their activities to discounting self-liquidating bills only (or lent against business transactions moving salable merchandise to the ultimate cash-paying consumer only), they were merely supplementing the efforts of the Discount House, and no fraud would be involved. Fraud appeared when they started emulating the Acceptance House.

The banks, no less than the Discount House, cannot create credit. They negotiate it. The credit acash-paying consumer. In discounting only self-liquidating bills, or in lending only against such collateral, the banks merely make the credit more

convenient and more negotiable. This is legitimate business, it is a healthy form of using credit. The Austrian School is mistaken in bundling it together with other forms of credit expansion causing economic harm, such as discounting anticipation, accommodation, and any other types of fiduciary bills, or in lending against such collateral, emulating the harmful practices of the Acceptance House. In doing so the banks practice illicit interest arbitrage. No longer are they engaged in legitimate business, but in a form of credit-abuse. Just like the Acceptance House, the banks fraudulently raise funds in the bill market at the discount rate and peddle them in the bond market at the rate of interest. In the process they appropriate the spread between the higher interest rate and the lower discount rate, to which they they are not entitled.

Notice non-disclosure, misrepresentation, and lack of transparency in the banks' procedure. The fraudulently drafted paper and other dubious or illiquid assets are now sheltered in the banks' portfolio. They are no longer available for public examination, as they have been earlier when the Acceptance House was trading them in the bill market. It is true that bank examiners could scrutinize these assets but, to the extent that they are paid by the government, they will follow norms adopted by their paymaster. It is clear that government wants to classify Treasury bills as paper eligible for discounting, or to be used for collateralizing loans. Therefore the stage is set for subverting the system of bank inspection. The problem of money and credit is thereby reduced to that of non-disclosure, misrepresentation of banking assets, and lack of transparency. The fictitious bills are withdrawn from circulation where they could be recognized and rejected by the public, and buried in the bank's portfolio where they could not. Exposure of fraud and conspiracy has become more difficult, and illicit interest arbitrage harder to detect.

This raises questions of responsibility. Accounting standards and the agenda for bank examiners are set by the government. Inclined to favor a minority at the expense of the majority, the government has succumbed to the temptation, allowed compromising accounting standard and covering up fraud and conspiracy. Moreover, the government has embarked upon the path of promoting its own Treasury Bills as money. This is the worst kind of government incursion in the banking business, short of nationalizing it. The practice of the government furnishing illiquid assets for bank portfolios, while maintaining the pretense of liquidity, has been greatly expanded in the twentieth century, and is now more wide-spread than ever. It is further reinforced by distorting the theory of banking.

The government is charged with the task of managing the nation's economy as well as its money supply. By allowing its debt to be used for the purposes of monetization by the banks, the government has appointed itself as dictator of the economy. It can order economic participants to obey its orders, punishing those who resist, with the carrot of the money supply and the stick of high taxation.

Another way of describing what has happened is this. By overtaking the bill market, the banks have hijacked the social circulating capital. They have put all the producers and distributors as well as a large part of the consuming public permanently in debt to themselves. We may recall that the social circulating capital used to possess a great momentum of its own, so that lending could be replaced by clearing. The banking fraternity, under leave from the government, has reversed this. The spontaneity of bill circulation has now been replaced by the duress of bank lending. In other words the banks, through their control of the social circulating capital, hold society to ransom.

Self-Liquidating Loans

According to Ludwig von Mises all the note and deposit liabilities of the banks in excess of capital accounts and vault cash are inflationary and contribute to credit expansion. They tend to suppress the rate of interest below the level that would obtain in the absence of bank lending. Mises does not recognize the idea of self-liquidating loans that finance the movement of merchandise and are to be repaid in 91 days or less from the proceeds of the sale of that merchandise to the ultimate cash-paying consumer. Nor does he recognize the essential difference between the interest rate and the discount rate. Yet these two rates are entirely independent of one another as their changes are autonomous. Either may be stationary while the other moves. If both move, they may move in the same or in the opposite direction. The very forces governing changes of either are different. The discount rate is governed by the propensity to consume, while the rate of interest is governed by the propensity to save. As other quantity theorists, Mises holds that lower propensity to consume necessarily means higher propensity to save. Yet this is a palpably false proposition: it is possible that people decide to withhold gold from both the bill and bond markets. The only connection between the two rates is that the discount rate is not supposed to rise above the rate of interest. It is true that illicit interest arbitrage may drive the discount rate above

the rate of interest temporarily. It will take a separate course of this University to investigate the consequences of this. We refer to the great topic of the business cycle.

Short-term self-liquidating loans by the banks are loans in form only. In substance they are instances of clearing, in exactly the same way as bills of exchange are. In effect, the bank discounts bills of the producers and distributors. The resulting 'loans' are definitely non-inflationary. The reason is that those bills could in fact circulate on their own. The bank has to withdraw them from circulation (or to preempt them from entering circulation) when making a self-liquidating loan. There is no net increase in the volume of purchasing media. The underlying credit exists on its own merit. *It would exist even in the complete absence of banks.* To put this differently,self-liquidating loans represent not lending but clearing activity. Only by abuse of language can they be called loans. This is most unfortunate, as the functions of lending and clearing ought to be kept separate, and should under no circumstance be confused. Only then can one see that there is no increase in the volume of purchasing media as a result of the bank extending a self-liquidating loan. I repeat: the bank is not issuing credit; it is merely negotiating it. The credit already exists on the strength of the urgent demand for the underlying consumer good. The bank merely substitutes its own credit (which is more convenient and more negotiable, and recognized more widely) for the credit of the producers and distributors (which may be less convenient and less negotiable, and recognized less widely). Whether the credit is in the form of a bill of exchange, or in the form of a self-liquidating bank loan, its circulation simply mirrors that of the underlying merchandise in urgent demand.

Mises and the Social Circulating Capital

Of course, not every consumer good is such that its movement can be financed by self-liquidating bank loans. Slow-moving merchandise, durable goods sold on installment plans as opposed to cash payments in full are some of the examples that don't qualify. Such goods are no part of the social circulating capital, as Adam Smith characterized the mass of fast-moving goods on their way from the producers to the ultimate cash-paying consumers that will reach its destination in 91 days or sooner. Certain merchandise may at one point in time belong to the social circulating capital only to fall out of it later as a result of changing consumer

tastes and habits. Other merchandise may regularly enter in and out of the social circulating capital following the seasons. Heating fuel and seasonal clothing are examples. This highlights the rationale for limiting the terms of self-liquidating loans to 91 days. Under no circumstances must the term for such loans be extended by the bank. Financing the movement of merchandise that may take longer than 91 days to reach the consumer is not the task of the commercial bank that 'lends' at the discount rate. It is the task of the investment bank that lends at the higher rate of interest.

Mises recognizes neither the bill of exchange nor the self-liquidatingt loan as a non-inflationary source of credit. Neither does he make a distinction between the discount and interest rates. Most glaring is the failure of Mises to accept the existence of social circulating capital. Although Mises often talks about the importance of urgent consumer demand and the significance of consumer's choice, he fails to draw the necessary consequence which is as follows. The most urgently demanded consumer goods are distinguished by the market in being given preferential treatment: their movement to the consumer need not be financed through lending. Items in the social circulating capital finance their own movement through clearing. It is indeed most unfortunate that Mises and other sound-money economists have failed to make the important distinction between self-liquidating loans of the commercial banks and other loans that investment banks may make. As a consequence of this failure they have to condemn all bank lending in excess of capital accounts and vault cash as inflationary, which is a grave error.

100 Percent Gold Reserve Banking

Some sound-money theorists such as Murray Rothbard see the solution to the problem of credit abuse in the so-called 100 percent gold reserve banking. They suggest that banks should maintain 100 percent gold reserves against all their outstanding credit. No bank is supposed to lend in excess of capital accounts and vault cash. However, this dogmatic approach throws the baby out with the bath water. The prescription has been made on the wrong diagnosis of the problem. The problem is not that banks lend against assets other than gold. The problem is that banks borrow short in order to lend long. In their lending practices banks make commitments not justified by the quality and maturity of the assets they hold. Advocates of 100 percent gold reserve banking are barking up on the wrong tree.

They have missed the real culprit, illicit interest arbitrage. The problem of bank illiquidity is not going to be solved by the 100 percent gold reserve requirement, but by prescribing that banks discount eligible paper only. Consumer demand is seasonal as well as unpredictable. Accordingly, the supply of purchasing media must be elastic. It must flow and ebb with consumer demand. It must vary with the seasons. Without an elastic supply of purchasing media the distribution of consumer goods may seize up amidst plenty. In addition, one must also face the problem of financing the production and distribution of consumer goods most efficiently, and without hindering technological progress. This progress can be illustrated in terms of refinements in the division of labor. 100 percent gold reserve banking would imply that every new refinement must mean another invasion of the pool of circulating gold coins. Under these condition the gold standard would be a fetter upon technological progress.

Do Banks Create Credit out of Thin Air?

Banks do not create credit out of thin air, as suggested by Mises[2] in his *Theory of Money and Credit*. To the extent they restrict their portfolio to self-liquidating loans, they do not contribute to credit expansion. They merely make credit that already exists by virtue of the very movement of merchandise to the consumer more negotiable. This is certainly a legitimate activity of the banks. To the extent the banks lend against assets other than self-liquidating paper, they borrow short to lend long. They raise funds in the bill market to place them in the bond market. Although this is an extremely lucrative business, it is illegitimate nevertheless. The banks pocket the spread between the higher interest rate and the lower discount rate to which they are not entitled: they make no contribution to the production process. In this case, no less than in the previous, bank credit is not created out of thin air. Borrowing short to lend long is no prestidigitation. *It is fraud.* It is fraudulent to arbitrage funds from the bill to the bond market. The way to see that the bank is guilty of illicit interest arbitrage is to examine the maturity dates in the bank's portfolio of assets, including the maturity of the collateral. If the bank is willing to extend the maturity of its loans beyond 91 days, or if it lends against assets that are not self-liquidating, or if it buys such assets for its own account,

[2] *The Theory of Money and Credit, by Ludwig von Mises, Indianapolis: Liberty Classics, 1980, p. 279 and p. 390.*

then the bank is engaging in illicit interest arbitrage. Through non-disclosure and misrepresentation these illicit transactions are disguised so that they can no longer be detected by the public. Illiquid assets are buried deep in the portfolio and start to metastasize in the banking system. No longer is there a limit to the size of bank assets. (In the absence of illicit interest arbitrage social circulating capital set the limit.) Now that the limit has been removed, the pressure is on for the banks to increase their assets in order to maintain profit-levels. One bank drops an innocuous snow ball on the mountain slope, unmindful of the danger that the size and momentum of the innocuous snow ball could increase rapidly, eventually destroying entire villages down below in the valley. The dropping of the snow ball is the beginning of the business cycle; the avalanche is the depression into which it may degenerate. As detection of credit abuse becomes harder, the business cycle started by the banks is even more devastating than that started by the Acceptance House.

Banks are guilty of usurping power over the social circulating capital. They are guilty of extortion: they pocket the spread between the rate of interest and the discount rate to which they are not entitled. The banks are guilty of conspiring against the public interest, just as the miller and the baker were in accepting anticipation and accommodation bills in the hope of illicit gains. The conspiracy of the banks is far more ominous: distortions and misallocations caused by the banks' illicit interest arbitrage are cumulative and potentially very damaging. Ultimately, they must lead to a credit collapse.

We must conclude that the banks are not creating credit out of thin air. It must be made clear for once and all that nobody can do that. The banks, aided and abetted by the government and its bank examiners, arbitrage funds from the bill to the bond market illegitimately. In doing so they are committing a serious crime against the public.

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Chapter 13

The Unadulterated Gold Standard

(Lecture Thirteen - Concluding Lecture)

Corruption of the Gold Standard - The Haberler-Pigou Effect - Critique of the Quantity Theory - The Gold Standard and its Relevance to Capitalism -

Corruption of the Gold Standard

The gold standard is a monetary system which, unlike the regime of irredeemable currency, is free of coercion. Its main significance is not to be found in the stabilization of prices, which is neither possible nor desirable, but in the stabilization of interest rates.

A gold standard is established when the unit of currency, or standard of value, is defined by the Constitution as a definite weight of gold of definite fineness. All other forms of currency are then redeemable in gold on demand at the statutory rate. To be effective, a gold standard must have a paraphernalia such as the standard gold coin, minted free of charge (exclusive of the cost of refining) at the Mint in unlimited quantities on the account of anyone tendering the metal. Furthermore, owners of the gold coins of the realm may hoard them, melt them, export them freely without penalty or the threat thereof. This right is part of the right to own property which cannot be curtailed, abrogated, or summarily suspended without due processes of law. It should be noted that, although the right of owning property in general may be subject to limitations and could be suspended temporarily in case of extreme emergency (a typical example is the ownership of grain in a town under enemy siege), gold is explicitly exempted from

this provision. A shortage of gold, unlike a shortage of grain, never gives rise to an emergency. The consumption of gold is mostly in the arts and jewelry, and is never for the satisfaction of the most urgent needs of society. A shortage of gold is always a symptom of mismanagement of the credit system by the banks, usually under the sponsorship of the government. If gold is in short supply, it simply means that individual citizens and creditors of the government are dissatisfied with credit policy. Hoarding gold is the only way they can protest effectively. They will release gold in their control as soon as they have been persuaded that the banks and the government mend their ways and they will keep their promises to pay. They will keep their sight liabilities within the limits of their quick assets. They will create no debts without seeing clearly how these debts can be paid. A shortage of gold, therefore, is not a real shortage and can be ended quickly through corrective measures in bank and government credit policies. The Constitution and the legal system should recognize this by specifically exempting gold from arbitrary seizure under sections of the legal code governing eminent domain.

The gold standard has been criticized for reasons of variation in the exchange value of gold. Critics have charged that gold is not sufficiently stable to serve as the standard of value. To assess this charge we must observe that variations in the exchange value of gold during the past 500 years were the result of the over-issue of fiduciary media redeemable in gold. In the absence of this abuse the exchange value of gold would have conformed to its intrinsic value governed by gold's marginal utility. Gold was promoted to the status of a monetary metal by the markets over thousands of years of evolution that has made the marginal utility of gold as nearly constant as possible (while the marginal utility of other goods is subject to steep decline, more or less. No other commodity would be more stable when used as money. Least stable is the irredeemable currency based on debt. We may therefore conclude that if the exchange value of gold appears undermined, the culprit is to be found in the unwarranted issue of fiduciary media by the banks under the sponsorship of the government. Moreover, this abuse takes the form of illicit interest arbitrage as we have seen in this course (Lectures 11 and 12). The criticism must be redirected from gold to the legal system of the country, which has failed to outlaw illicit interest arbitrage and borrowing short to lend long.

There is, therefore, need to re-define a gold standard in such a way that these credit abuses by the banks under the protection of the government are eliminated. In particular, the exemption of banks from the full penalty under contract law for breach of contract (including the right of creditors to sue for liquidation), and

the double accounting standard aiding and abetting banks guilty of understating liabilities and overstating assets, must be abolished. The definition of the unadulterated gold standard must stipulate the removal of all special privileges for the banks. It was these privileges that allowed banks to carry on business as usual after they have defaulted on their promises to pay gold to their depositors. It was these privileges that have let banks borrow short to lend long. It was these privileges that made it possible for them to milk society through the practice of illicit interest arbitrage. The very idea that banks may be allowed to suspend payments in gold coin *and continue in business* is preposterous. The gold coin is there, in the first place, to protect the bank's creditors against unsound credit practices. Legalizing suspension is tantamount to condoning the practice of declaring bankruptcy fraudulently, and to confirming the thief in the possession of stolen goods. At any rate, legal protection of banks against the legitimate claims of creditors rewards incompetence and fraudulent behavior while penalizing competence and integrity. With such a code, problems will never be solved, only compounded.

Arbitrage *versus* Speculation

Critics who argue that the gold standard is inherently unstable confuse the instability of a metallic monetary standard with that of the credit of government. They also betray their ignorance of the difference between arbitrage and speculation. No government per se can keep the value of the currency stable, except by the good offices of the arbitrageur. If he is persuaded about the good faith behind the promises of the government, then he will step in every time there is a deviation between the nominal and the market value of paper currency in order to restore parity. It is well-understood by students of metallic monetary standards that arbitrage is the catalyst whereby the value of paper currencies is maintained. But the arbitrageur will carry on his beneficial activities only if he is fully convinced of the good faith of the government. He will support the value of the government's promise only if it is worth supporting, the judgment being based on past performance, present policy, and future intentions. A government that has a record of periodic lapses into bad faith, that makes promises frivolously, that has inclination to declare bankruptcy fraudulently (more commonly known as devaluation) is inviting the arbitrageur to stop supporting its currency.

In actual fact, conditions influencing the credit of government can be even more precarious. Not only may arbitrageurs, whose support alone maintains the value of government paper, withdraw their services *en masse* and without notice. Worse yet, speculators would be happy to step into the shoes abandoned by the arbitrageurs, and cause massive harm to the credit of the government. The behavior of the speculators is as different from that of the arbitrageurs as night is different from day. The speculators are specialists in making a market in paper of dubious or uncertain value. They make it their business to study which currency is the weakest and is most likely to fall next. They are totally immune to double talk and the siren song appealing to "patriotism". Speculators treat paper currency most disrespectfully. They sell it short. They buy it only at a deep discount. They are very strong: they can make governments eat their words. They know exactly how to respond to the government's loud declaration that "the national currency will never ever be devalued." In this cat-and-mouse game, the role of the mouse appears to have been assigned to the government.

Currency speculation, just as bond speculation, was virtually unknown under the gold standard. There was only beneficial arbitrage. The sycophant chorus of financial writers and economics professors has never been able to grasp this fundamental fact governing the gold standard. The strength of the gold standard is not grounded in mythology. It is grounded in the superb confidence that arbitrageurs have in the government's promises to pay gold. Once the government destroys the basis for this confidence, arbitrageurs vacate the field which is subsequently occupied by a new breed, the currency and bond speculators. With arbitrage gone, speculators have a field day. They dictate currency values unopposed. They ratchet down the value of all irredeemable currencies, one after another, going after the weakest first. This may make the false impression that the strongest currency is indeed a strong currency. Well, it is not. In no way is it strong in the absolute sense of the word. One can only talk about relative strength: even the strongest currency is losing its value over time, albeit more slowly than the others, but losing it nevertheless.

The Tyranny of Gold

Things are very different under a gold standard. If the government has a record of performing punctiliously on its promises to pay gold, if there is no reason to

question its good faith, if it has a policy to balance its budget and it can show the revenue that will retire its outstanding debt, then gold comes out of hiding and will flow to government coffers in exchange for paper promises to pay gold. The only competitor gold money may have, and that is a formidable competitor indeed, is the promise of the government to pay gold. If the promise can be trusted, then the value of paper will be kept on a par by the arbitrageurs through thin and thick. Here is what Benjamin M. Anderson[1] had to say about the tyranny of gold.

> *"Gold is an unimaginative taskmaster. It demands that men, banks, and the government be honest. It demands that they create no debt without seeing clearly how these debts can be paid. If a country will do these things, gold will stay with it and come to it from other countries. But when a country creates debt light-heartedly, when a central bank makes interest rates low and buys government securities to feed its money market, and permits an extension of credit that goes into slow and illiquid assets, then gold grows nervous. There comes a flight of capital out of the country. Foreigners withdraw their funds from it, and its own citizens send their liquid funds away for safety."*

Legal Tender

Under a gold standard the gold coin is the only legal tender. This means that only the gold coin is acceptable in unlimited quantities in discharge of debt, not by coercion but by the free choice of the contracting parties. Other means of payments are acceptable within legal limits or at the risk of the receiver. It is important to realize that the original concept of legal tender has nothing to do with coercion as it does today. It is a corollary of the principle of the sanctity of contracts. A search of financial annals fails to reveal an instance of a creditor ever protesting payment in gold coin as contracted. Originally, legal tender legislation referred to tolerance standards of circulating coins (see Lecture 9). Commerce is greatly facilitated if gold coins circulate by tale rather than by weight, thus bypassing the cumbersome and time-consuming process of weighing. But then a practical problem arises: creditors may refuse to accept at face value coins that are worn

[1] *Benjamin M. Anderson, Economics and the Public Welfare, a Financial and Economic History of the United States, 1914-1946, Princeton, 1949. Chapter 64.*

more or less, thus undermining the efficiency of the gold standard. The problem is solved by introducing legal tolerance standards regulating the minimum weight of a gold coin that is still allowed to circulate by tale, while making substandard coins circulate by weight. There is no coercion involved. Creditors are not coerced into accepting at face value gold coins with impaired weight. Legal tender legislation, as conceived originally, obliges the government to cover losses caused by wear and tear of coins in circulation. The Mint will accept at face value worn gold coins within the limits of tolerance, and will replace them with newly minted ones. The government absorbs the loss. This is comparable to its function of maintaining public roads in good repair. This wise provision is enacted to facilitate commerce. It is unfortunate that the meaning and purpose of legal tender legislation was later distorted and made an instrument of coercion. Today legal tender laws are a travesty of justice. They pretend to protect the public; in actual fact, they protect special interests. Today legal tender means that creditors are coerced into accepting dishonored promises to pay in final discharge of debt, and no amount of sophistry can change that fact. Everybody who accepts and holds an irredeemable bank note is a creditor of the government holding evidence of indebtedness that cannot be validated as a consequence of legal tender legislation. The general public stands to be victimized by this piece of chicanery changing the original meaning of the term legal tender, as the 90 percent loss in the purchasing power of the dollar during the 1970's has forcefully demonstrated.

Unadulterated Gold Standard

Under a gold standard the stock of circulating medium has three components: (1) the gold component, (2) the clearing component, and (3) the fiduciary component. The *gold component* consists of the gold coins of the realm in the hand of the general public plus that part of bank notes and deposits which are covered by reserves in the form of gold. The *clearing component* consists of maturing bills of exchange in the hands of the public plus that part of bank notes and deposits which are covered by assets consisting of such bills. The *fiduciary component* consists of that part of bank notes and deposits which belong neither to the gold not to the clearing component. The gold standard is called *unadulterated* if the stock of circulating medium has no fiduciary component. This means that the banks issue no bank notes and create no bank deposits except when buying gold or discounting

a bill of exchange. Bills eligible for discounting is strictly limited to those drawn on merchandise on its way to the final cash-paying consumer, with maturity no longer than 91 days. In particular, the banks are not in the business of discounting finance bills, anticipation and accommodation bills, treasury bills, and they buy no stocks, bonds, or mortgages in excess of their liabilities on capital account.

The Haberler-Pigou Effect

The most important consequence of establishing an unadulterated gold standard is that *an across-the-board increase in the prices of consumer goods is no longer possible.* Such an increase would immediately trigger the Haberler-Pigou effect as follows. The consumer controlling the gold coin could effectively resist higher prices by delaying his purchases, buying alternative products, or by patronizing outlets selling at the old price. This consumer action would roll prices back, should an across-the-board increase in prices ever occur. The fact is that such an increase would inflict capital losses on the consumer, which would show up in the consolidated balance sheet of the nation. He would have to recoup the loss by restraining consumption. This restraint is the driving force behind the roll-back of prices. Note, however, that the *Haberler-Pigou effect does not operate on the fiduciary component of the stock of circulating media.* To the extent that fiduciary media are in circulation, the effectiveness of the protection that the gold coin provides to the consumers is undermined. The consumers may, if they care, try to combat higher prices by delaying or limiting purchases or by shifting custom. It is still true that they have suffered a capital loss but, because they are creditors to the extent of their holdings of fiduciary media, another group of people 'their debtors' will experience capital gains equal to their capital losses. The effect of the stepped-up spending of the latter offsets that of the spending restraint of the former, thus validating the price advances. The consolidated balance sheet of the nation shows no change, hence individual resistance to higher prices remains ineffective. The price level under the adulterated gold standard and, for the stronger reason, under the regime of irredeemable currency, is no longer stable. If a country wants a stable price level for consumer goods, it will have to adopt the unadulterated gold standard.

The Quantity Theory of Money

Detractors of the gold standard argue that fluctuations in gold production influence the price level adversely. In particular, a decline in gold production causes deflation, economic contraction, and unemployment. This is false. In deflation prices fall and in response marginal gold mines go into production. The quantity theory is a very crude device which would be valid only in the antiseptic world where credit is non-existent, and all payments for consumer goods are made in gold coin, where merchandise is always consumed upon purchase and never re-sold. In reality, a large part of payments in a modern economy are for future delivery, often for products not yet in existence. Even if payments are for immediate delivery, the goods can be sold and re-sold several times before they disappear in consumption. As we have seen, the theory of social circulating capital is the exact opposite of the quantity theory. It demonstrates that the supply of consumer goods is determined by demand. Moreover, the mechanism that makes the adjustment of supply to demand operates, not on prices, but on the discount rate.

A second, even more serious objection to the quantity theory of money is that, as its name suggests, it is completely blind to the *quality* of circulating media, the stock of which has many components each of different quality. This is especially important in the case of components consisting of credit instruments. The government can, of course, make the quality of purchasing media uniform by centralizing credit. However, this can never improve the quality of the currency, but can make it deteriorate. It is well-known that credit instruments of inferior quality go to a discount in the markets. It is disingenuous to explain away currency depreciation by quantitative arguments. First, there are obvious examples showing that credit instruments of inferior quality can lose all their market value *even if their quantity is constant or decreasing*. Second, even if it were true that historically all currencies losing their purchasing power showed a simultaneous increases in their quantity, this would not establish a causality relation between the quantity and the purchasing power of money. The chain of causation may well run in the opposite direction. Several qualified observers noted that in hyperinflation an acute *shortage* of the circulating medium develops owing to the accelerating decline in the purchasing power of the monetary unit, and the central bank is under pressure to put more bank notes into circulation than originally intended, in order to alleviate the shortage.

This means that in fact there is no unambiguous causality relation between the quantity and the purchasing power of the circulating medium. The only way to get to the crux of the matter is to study the *quality* of the circulating media or, if they have been made homogeneous by the centralization of credit, then to analyze the history and the marketability of the assets on the books of the monetary authority balancing its note and deposit liabilities. Several authors argue that the quality of credit is of no significance because, thanks to legal tender legislation, creditors are obliged to accept irredeemable currency in discharge of debt in any amount without demur. This is a shallow, not to say cynical, answer to a problem that deserves a deeper and more earnest analysis.

Basically there are two sides to the problem: the behavior of domestic and foreign creditors. As the writ of the government stops at the border, the latter are not bound by legal tender legislation. Foreign creditors are not in the habit of giving advance notice of their intention to dump the paper of a government to which they owe no allegiance. This shows that the quantity theory puts the country's resources embodied in its foreign credit into jeopardy. This is a very serious matter even if the country in question is self-sufficient in essential raw materials. Considering the behavior of domestic creditors, the problem boils down to the question whether the producers of goods and services will indefinitely keep exchanging real goods and services for irredeemable promises to pay which, by their very nature, constantly depreciate in value. If history is any guide, then these merchants and workers will not allow the government to victimize them indefinitely. They can do something about it. *They could re-invent bill-circulation.*

The World Without Banks

People who handle the social circulating capital have, without realizing it, a most potent instrument in their hand, namely, the bills they still keep drawing on one another. Presently the movement of goods to the consumer is financed by bank credit of questionable quality. However, as in Argentina and Brazil for example, banks are progressively discrediting themselves in the eyes of the population. When the payment system breaks down, there will be starvation amidst plenty and, rightly or wrongly, the banks will be made scapegoats. At that point bills drawn on merchandise in urgent demand will start to circulate, replacing irredeemable paper issued by the government.

It is futile to speculate about the future course that history may take. But it appears that the rise of an international bill market on merchandise in most urgent demand is ultimately inevitable, if an all-out trade war is to be averted. Such a bill market would be the most potent force in the preservation of international division of labor. It would be a precision-instrument activating instant changes in the direction, size, and composition of the flow of short-term capital to countries that need it most urgently. No time would be lost in negotiating government credits, doing legal work and other formalities. Moreover, short-term capital would be dispatched to the country in need in the form of consumer goods which were in most urgent demand. If the discount rate in a country rose above the level prevailing elsewhere in the world, consumer goods would be dispatched on the same day to that country, since it was a good place on which to draw bills. It would be the discount rate that would direct the flow of short-term capital world wide, rather than political considerations. The nimbleness of the discount rate, and the instantaneous response to its changes by drawers and acceptors of bills, would be the guarantee of each and every country adhering to the international gold standard that the full complement of international division of labor stood by in the hour of its need to help solve its problems quickly and efficiently. Far more quickly and efficiently than autarky or politically motivated inter-governmental assistance ever could.

The Mistake of Sound-Money Advocates

This marvelous instrument, the bill market based on the international gold standard, was the first casualty of the guns of August in 1914. The governments of the garrison states that emerged after the cessation of hostilities did not allow the bill market to make a come-back. There has been no bill-trading on a world-scale for the past eighty-eight years. In spite of prodigious increases in world trade, it took eighty years to surpass the volume prevailing in 1913. Today foreign trade and relief is the business of the governments (i.e., none of your business). The direction, the size and composition of foreign trade is determined by political considerations, rather than by need. People who control liquid funds are intimidated. If they send their funds abroad in search of better returns, those funds may be frozen by foreign exchange controls, and may be subject to capital losses due to currency devaluation. Foreign trade is at the pleasure of the governments which could slam on tariffs,

quotas, or punitive embargo without notice. Even in countries that tolerate import and export on private account, trade is subject to lengthy licensing procedures and other government controls. By the time the permit is issued, the opportunity to import or export profitably may well be lost. Profits are impossible to calculate due to the daily (or hourly) variation in foreign exchange rates. International division of labor and individual self-reliance are reduced to insignificance, while everybody is made utterly dependent on government largesse and ukase.

Advocates of sound money made a grave mistake at the end of hostilities in 1918 when, in demanding a return to the gold standard, they failed to call for a full rehabilitation of the international bill market. They allowed the banks to hijack the social circulating capital, thereby disenfranchising the producers and the savers. Instead of an unadulterated gold standard, the politicians set up an international gold standard of a most adulterated kind: the gold bullion and the gold exchange standard. In the 1920's there was much talk about the shortage of gold. In actual fact the shortage was caused by the deliberate policy to withdraw gold coins from circulation and to replace them with bank notes of small denomination. When people see that the government is out to grab the gold coin, their natural reaction is to clutch theirs ever so tightly. The correct policy should have been to place gold coins in the hand of the consumers, and trade should have been financed by bill circulation. The gold shortage would have disappeared as if by magic, facilitating reconstruction. Instead, an orgy of debt pyramiding, commodity, real estate, and stock market speculation followed. The debt pyramid collapsed at the end of the 'Roaring Twenties' giving way the Great Depression. Ever since the international monetary system is "on a 24-hour basis", meaning that it is a non-system based on constant government meddling. The gold standard was doomed, as it was no longer reinforced by a bill market linking the flow and ebb of circulating media to the flow and ebb of newly emerging merchandise in the markets.

These mistakes must not be repeated now. The Mint should be opened to gold at once. If the U.S. government refuses to do that, it will run the risk that the regime of the irredeemable dollar will collapse, causing enormous economic pain to the American people, similar to the pain the people of Argentina are now put through. As a solution to the problem, gold coins should be placed directly in the hand of the consumers, and trade should be financed by bill circulation. *There is no need to give blood transfusion to the banks.* Let them die in peace.

The Relevance of the Gold Standard to Capitalism

This is the last Lecture of the course entitled *The Real Bills Doctrine of Adam Smith*. I conclude with a brief preview of the next course in our series entitled *Gold and Interest*.

Let us raise the question: what is capitalism? In its simplest form capitalism is an economic system which is based on the conception that individuals should and would produce as generously as possible and live on something less than they produce, in order that they may posses a residue in the form of property to insure the education of the young, the support of the elderly, and other future projects. However, in order to achieve these ends we must have a facility to exchange income for wealth and wealth for income. Interest, in this view, is not a premium on present goods as opposed to future goods, but the indicator of the efficiency of converting wealth into income and income into wealth. In particular, zero interest marks the least efficient way of converting, namely, the conversion of income into wealth by hoarding gold, and of wealth into income by dishoarding it.

Capitalism is an economic system that makes the spontaneous capitalization of incomes possible. In more details, capitalism means unobstructed and uninhibited capital formation through the voluntary partnership of the annuitant (typically an elderly man drawing an annuity) and the entrepreneur (who pays the annuity income from the return to capital put at his disposal in the form of wealth of the annuitant). Capitalism means a gold bond market where the residual savings of the people are pooled, parceled, and allocated. In the gold bond market the marginal producer is free to perform his function as arbitrageur between two types of earning assets: capital goods and gold bonds. It is this arbitrage that validates the marginal productivity of capital in fixing the *ceiling* for the rate of interest. Capitalism means a gold standard without which the marginal bondholder would be unable to perform his function as arbitrageur between present goods (gold) and future goods (the gold bond). It is this arbitrage that validates the marginal time preference of the saving public in fixing the *floor* for the rate of interest. Capitalism means a bill market where the marginal shopkeeper is free to perform his function as arbitrageur between the two forms of social circulating capital: fast-moving merchandise and bills drawn on them. It is this particular arbitrage that validates the marginal productivity of the social circulating capital, in fixing the discount rate.

Insofar as gold is the indispensable catalyst of spontaneous capitalization of incomes, the government's deliberate destruction of the gold standard is to be considered a major step towards the destruction of capitalism. Government intervention in the bill and bond markets may bring no possible benefit to society, and is likely to make conditions for human welfare worse. Intervention in the bill market falsifies the discount rate, and intervention in the bond market falsifies the interest rate. The falsification of these important indicators causes serious misallocation of resources and paralyzes the regenerative faculty of the economy. It will, ittle-by-littlel, destroy our distinctively human symbiosis: the peaceful and voluntary cooperation of individuals under the system of international division of labor. This symbiosis was the vision of the greatest practitioners of our science: Adam Smith, Carl Menger, and others. The invisible hand of the market, through the signal system of prices, discount and interest rates, guides the 'selfish' pursuits of individuals, and harnesses their efforts for the greater benefit of the commonweal. In the words of the Bard: "One for all, all for one we gage."

And this shall remain the best hope for mankind.

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